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14 February 2020

Phil Oakley's Weekly Round-Up

In my experience, chief executives should have 'skin in the game' and put their own money in businesses they run, to reassure other shareholders

The companies mentioned this week are:
- Ocado
- Dunelm
- RELX
- MJ Gleeson
- Centrica

Skin in the game
Investors should rightly insist that the management of the company they own shares in should have a meaningful shareholding in the business as well. You want to see them eat their own cooking. After all, if they aren't prepared to do so, why should you invest?

Yet, it still never ceases to surprise me how little directors eat of their own cooking. I still come across businesses where the chief executive, finance director or a senior divisional manager have very little invested, compared with how much they are taking out in pay and bonuses every year.

Some point out that they are incentivised by share options. The problem with this argument is that the granting and subsequent exercising of those options come at the expense of shareholders. You want to see directors putting their hands in their pockets and putting some serious money – their own money – into the business they are running and want people to invest in.

How much is enough?

I used to have this discussion with chief executives from time to time when I worked in the City. I came to the view that having a stake that was worth at least double their basic salary showed a decent commitment to the business and one that should give outside investors confidence that they

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had ample “skin in the game”.

The buying and selling of shares is closely scrutinised by investors, and rightly so. We have a page dedicated to them every week in the Investors Chronicle. A general rule of thumb is that sizeable purchases are positive and a sign of confidence in the business whereas large sales are the opposite.

This is not always true in the case of share sales. Sometimes some shares have to be sold to pay tax bills, to raise cash for divorce settlements or to exercise share options.

But often significant share sales by a director or directors can get you to raise an eyebrow. It’s not uncommon for directors – who know their business better than outside shareholders – to sell a significant amount of shares when they are highly valued or after they have racked up significant gains. In some cases, and with the benefit of hindsight, these sales have often called the top of the market for a particular share.

Games Workshop: Director shareholdings

Director	Shares sold	Shares retained	Value @ £71.20	2019 base salary	Shareholding to salary
Chair	3300	16700	£1,189,040	£140,000	849%
CEO	10000	5793	£412,462	£551,000	75%
FD	4700	5314	£378,357	£311,000	122%

Source: Annual report/ Company announcement

All of which leads me to the significant sale of shares by directors in Games Workshop this week. The chief executive and finance director have sold a significant proportion of their shareholdings in the company.

Is it a sign of trouble ahead?

No one knows for sure. It is important to note here that directors cannot sell shares based on information about current trading that has not been made public. So a share sale in this case should not be taken as a sign that trading has taken a turn for the worse.

In fact, Games Workshop is doing very well and so is its share price.

I have recently done a detailed analysis of Games Workshop in the magazine and it is a business that I like a lot. The management has done a fabulous job in engaging with customers and driving sales and profits higher.

However, Games Workshop is in somewhat unchartered territory. Historically, it has been a business that has had its ups and downs, as its Warhammer product ebbs and flows in popularity. It is currently riding a wave of enthusiasm, which is seeing rapid sales growth utilise the significant operational gearing of its manufacturing base and deliver even bigger increases in profits.

It’s not unreasonable to ask how long the good times

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will last. If Warhammer is a long-term growth business then shareholders could still make a lot of money from the shares. That said, the company is adding more production capacity and with it more fixed overhead and operational gearing. If sales ever start to go into reverse and the capacity of its production lines are not kept busy then profits could take a big dive.

This risk is certainly not reflected in the current share price of 7,120p, which equates to a one-year rolling forecast price/earnings (PE) of over 29 times. I certainly wouldn't blame anyone for selling some shares after such a big rise in the share price over the past couple of years.

But the chief executive and finance director of Games Workshop now look as if they don't have enough skin in the game. The CEO's shareholding is currently worth just 75 per cent of his basic salary of last year, with the finance director's worth 122 per cent.

A warning sign for investors? Possibly, yes. The high valuation and an understanding of operational gearing should have already alerted more diligent investors and I'm not sticking my neck out when I say that the CEO and finance director will understand both better than most.

Games Workshop is an excellent business which has been managed well. Its profits and share price may still go higher, but having banked a very quick 15 per cent gain since the start of 2020, I have decided that I do not have enough confidence on the business' sustainable revenues and think the valuation and operational leverage make the shares a high risk. I have therefore sold my holding in the UK Quality Shares portfolio and will look to reinvest the cash elsewhere in the coming weeks.

Fantasy Sipp & UK Quality Shares Portfolios

	Portfolio % returns			
	1 month	Year to date	1 year	2 years
LF Blue Whale Growth Fund	4.4	8.7	25.6	50.2
Scottish Mortgage Investment Trust	4.2	8.3	26.1	43.6
Martin Currie Global Portfolio Trust	4.0	7.9	29.5	42.7
Phil Oakley Fantasy Sipp	**3.6**	**6.6**	**30.3**	**47.7**
Fundsmith Equity T Acc	3.5	6.4	22.1	40.9
Vanguard S&P 500 ETF	2.3	5.8	20.7	35.4
Smithson Investment Trust	2.1	4.5	23.3	
Mid Wynd International Inv Trust	2.1	3.8	24.9	32.9
Phil Oakley UK Quality Shares	**2.1**	**2.9**	**–**	**–**
Castlefield CFP SDL UK Buffettology	0.1	1.8	23.1	35.4
Lindsell Train Global Funds plc	-0.3	0.7	12.4	36.0
Finsbury Growth & Income Trust	2.1	0.6	13.9	29.0
FTSE All-Share - Total Return	-1.9	-1.2	9.9	14.1
Vanguard FTSE 100 ETF	-2.4	-1.5	8.2	12.6
Vanguard FTSE 250 UCITS ETF	-0.8	-1.8	16.5	17.1

Source: SharePad

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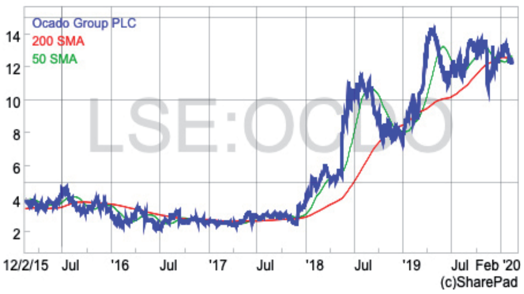

Ocado

I think **Ocado's (OCDO)** shares remain very overvalued and struggle to buy into the bull case about its retail technologies. The very simple reason for this view is that Ocado is selling its technology to other grocery businesses, but cannot make any real money from it itself.

There's undoubtedly some very clever people at US grocer Kroger and other businesses that have signed up to buy Ocado's robots and software, but the whole point of making a big investment in assets is to make a reasonable return.

If Ocado's own UK retail business was very profitable I might be more inclined to buy into the bull case, but it isn't. In 2019, it was good at attracting more customers with order per week up by 10.7 per cent to 325,000. This was offset by a 0.6 per cent decline in the average basket size to £103.18, but revenue growth and gross profit growth of slightly more than 10 per cent is a good result in a tough market.

This is where the good news ends. While revenues are growing, so are costs. All those extra orders have to be picked and delivered, which has meant that distribution costs increased faster than revenues. The point to make here is that there is no operating leverage apparent in this business where revenue growth can generate a bigger increase in profit growth.

To be fair to Ocado, its costs have been affected by the fire at its Andover customer fulfilment centre (CFC), which meant it had to use space at its new Erith CFC by asking Morrisons to move out. This meant that Ocado had to pay for all the fixed costs at Erith when they would have ordinarily been shared with Morrisons.

Retail Performance

	FY 2019[3] £m	FY 2018[3] £m	Variance
Revenue	**1,617.5**	1,466.6	10.3%
Gross profit	**466.4**	423.6	10.1%
Other income	**65.6**	59.8	9.7%
Distribution costs Ⓐ (1)	**(433.8)**	(388.4)	11.7%
Marketing (non-voucher)	**(21.2)**	(13.9)	52.5%
Other administrative costs Ⓐ (1)	**(56.8)**	(51.0)	11.4%
IFRS 16 Impact	**14.8**	–	–
EBITDA Ⓐ (2)	**35.0**	30.1	16.3%

Source: Annual report

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Earnings before interest, tax, depreciation and amortisation (Ebitda) did increase from £30.1m to £35m, but Ocado has not restated its Ebitda figure in 2018 for the move to the new accounting standard on operating leases (IFRS 16). This increases Ebitda as the depreciation and interest on the leased assets (the whole operating lease expense) is added back (£14.6m), compared with the old standard where it is expensed. So Ebitda under the old standard in 2019 would have been £14.8m lower or £20.2m.

On revenues of £1617.5m this is a very meagre return. I ask again: Why do other retailers want to buy Ocado's technology? I can see little evidence that it transforms the economics of food retailing.

If we look at Ocado's UK Solutions Business, which includes its contracts with Waitrose and Morrisons, revenue was up last year. Fee income growth – for using Ocado's technology – was up modestly whilst there was a big uplift in cost recharges (the cost of deliveries and CFC costs). Ebitda was up again largely due to lease effects which overstate it and actual growth is more modest.

UK Solutions & Logistics Performance

	FY 2019 £m	FY 2018 £m	Variance
Fee revenue	**109.9**	104.3	5.4%
Cost recharges[1]	**473.3**	436.8	8.4%
Revenue	**583.2**	541.1	7.8%
Other Income	**3.0**	2.6	15.4%
Distribution costs	**(468.4)**	(431.0)	8.7%
Administrative costs	**(43.5)**	(45.2)	3.8%
Share of JV	**(0.1)**	–	–
IFRS 16 Impact	**10.6**	–	n/a
EBITDAⒶ	**84.8**	67.5	25.6%

Source: Annual report

If we add the Ebitda of the UK Retail and Solutions & Logistics together we get a total of £119.8m. If we take away £96m of depreciation there is just over £23m left over. Amortisation of software and other costs – which are real costs – of just over £37m means that these businesses are not making enough money to cover these costs.

If we then move onto the International Solutions business – the bit that many people are excited about – the fees invoiced reflects the new contracts that have been agreed. There is no revenue of note yet as cash received cannot be recognised as such until Ocado hands over a fully operational CFC to its customer.

International Solutions Performance

	FY 2019 £m	FY 2018 £m	Variance
Fees invoiced	**81.4**	58.8	38.4%
Revenue	**0.5**	0.5	–
Distribution and administrative costs Ⓐ	**(62.5)**	(28.9)	116.3%
EBITDA Ⓐ	**(62.1)**	(28.4)	118.3%

Source: Annual report

Given the ramp up in costs to support current and future contracts, this business made a significant Ebitda loss.

Yet, it is the potential of this business that is being used to explain Ocado's current market capitalisation of £8.9bn. Buried deep in the notes to its annual accounts are the details of the future revenues and costs – and therefore the cumulative profits – that are currently expected to be earned from the contracts Ocado has signed. They are based on the agreed contract lengths and do not assume any extension or additional services.

The transaction price allocated to the remaining performance obligations (unsatisfied or partially unsatisfied) is as follows:

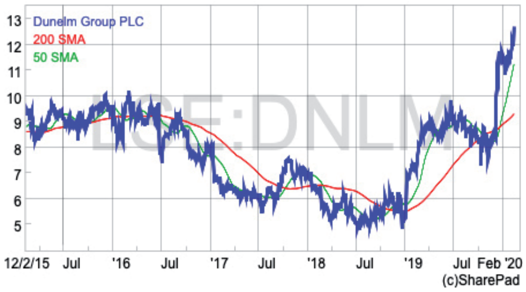
	1 December 2019 £m	2 December 2018 £m
Within one year	**114.5**	112.0
Between one and five years	**1,004.9**	833.4
More than five years	**3,308.8**	2,135.6
Total transaction price	**4,428.2**	3,081.0

Total transaction price includes £1,824.0 million (2018: £1,736.3 million) in respect of potential revenues in relation to the recovery of costs that are expected to be incurred in existing Solutions contracts.

Source: Annual report

We can see that the estimate of future cumulative profits over the past year has increased from £1,344.7m (£3081m less £1,736.3m) to £2,604.2m (£4,428.2m less £1,824m). This is an impressive increase, but note that it is not a present value of future profits in today's money. Ocado needs to sign a lot more contracts to justify its current market capitalisation in my view.

City analysts do not expect Ocado to make a profit any time soon, as investment in customer CFCs means that free cash flows are expected to be significantly negative for some time to come. Thankfully, Ocado raised £558m from selling half of its UK Retail business to Marks & Spencer otherwise it would probably have had to ask shareholders for more cash.



Ocado forecasts

	2019	(£m) 2020	2021
Turnover	1,772.20	1,996.60	2,263.70
Ebitda	27.1	51.5	113
Ebit	-89	-89.9	-52.9
Pre-tax profit	-114.1	-102.8	-86.6
Post-tax profit	-128.5	-98.9	-65.9
EPS (p)	-16.1	-14.2	-12
Dividend (p)	-	-	-
Capex	339.2	367.1	397
Free cash flow	-264	-274.2	-282.6
Net borrowing	-281.4	-19.7	176.5

Source: SharePad

I am happy to admit that I do not get the bull case for Ocado shares, but would point out that this is a business that is subject to high levels of uncertainty. No one knows for sure if its technology will pay off for other retailers and spark a deluge of new orders. While the joint venture with M&S in the UK is not certain of success given the doubts about M&S's limited range and much smaller basket sizes compared with Waitrose.

Dunelm

Dunelm's (DNLM) half-year results show a very good performance by the business in a very tough market. Despite the UK homewares and furniture market shrinking slightly last year, Dunelm managed to grow and take a bigger slice of the market.

The company's success is being driven by the rapid growth of its online sales which in turn are a testament to its product range, pricing and investment in customer service. Like-for-like (LFL) sales in its stores did slow during the second quarter, but still remained positive. Its online business continued its strong recent performance with LFL growth of 32.1 per cent. Online as percentage of total sales increased from 15.7 per cent to 19.2 per cent. This trend looks set to continue as the company moves a bigger selection of its products to online only.

Good cost control on purchasing stock and general overheads saw total revenue growth of 6 per cent feed through to operating profit growth of 23.9 per cent. Operating margins increased from 12.8 per cent to 15 per cent, which represents a very impressive level of profitability for a UK retailer.

Dunelm: Like-for-like sales performance

	52 weeks to 27 June 2020						
	Q1	**Q2**	**H1**	**Q3**	**Q4**	**H2**	**FY**
Total sales	**£262.6m**	**£322.4m**	**£585.0m**				
LFL Stores growth	2.9%	1.2%	2.0%				
LFL Online growth	34.7%	32.1%	33.2%				
Total LFL growth	**6.4%**	**5.0%**	**5.6%**				
Total Dunelm growth	**7.5%**	**6.1%**	**6.7%**				
Total Group growth	**5.8%**	**6.2%**	**6.0%**				
Gross margin growth	+130bps	+110bps	+120bps				

Source: Dunelm

The company seems to have profited by following the example of Next and not discounting its prices before Christmas. Stock control was excellent with no increase in the balance sheet value at all between June and December.

Consumer spending is hardly buoyant but seems to be holding up, which bodes well for Dunelm as it has been taking market share. I think forecast upgrades for the year to June 2020 are quite likely on the back of these results. Trailing 12 months (TTM) pre-tax profits are currently running at £139.5m and the company has issued an optimistic outlook statement:

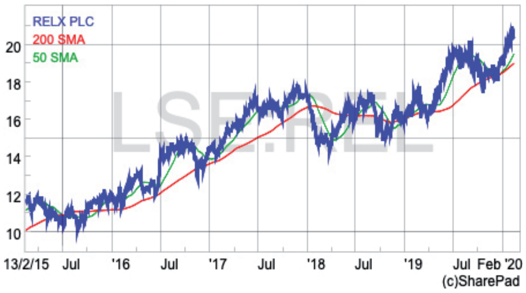
"The third quarter has started well, with a successful Winter Sale across the total retail system. As a result, we expect full-year FY20 profit before tax to be slightly ahead of the top of the latest range of analyst expectations. We are monitoring the Coronavirus outbreak carefully. To date we have not assumed any material disruption to our supply chain or any financial impact in the year."

That said, I think it's fair to say that upgrades are needed given that at Tuesday night's closing share price of 1,201p the shares traded on a one-year forecast rolling PE of 21 times. Having paid a special dividend last year, I think it is likely that another one in 2020 is very possible given the strength of the company's finances.

Dunelm forecasts

	2020	(£m) 2021	2022
Turnover	1,150.50	1,202.60	1,253.50
Ebitda	226.4	238.9	250.2
Ebit	143.2	149.9	155.5
Pre-tax profit	139	145.4	151.8
Post-tax profit	111.4	116.7	121.8
EPS (p)	54.7	57.4	59.9
Dividend (p)	30.1	44.1	32.7
Capex	30.5	30.7	31.3
Free cash flow	90.9	120.4	128.2
Net borrowing	67.4	56.9	28.6
NAV	151.2	181.8	213.1
Like-for-like sales growth (%)	6.5	4.2	3.7

Source: SharePad



RELX

One of the most profitable areas to invest in in recent years is data and information. Businesses that produce and control essential information have assets that are scarce and are often very difficult to compete against. This allows them to charge premium prices and make very fat profit margins. Stock exchanges are a great example of this and **RELX (REL)** is another.

RELX shares are part of my Fantasy Sipp and UK Quality Shares portfolio because I believe it has the ability to steadily grow and compound its highly profitable businesses over the years ahead.

For those of you that aren't too familiar with what this company does, I have provided a brief overview of the business which is split into four separate divisions:

- Scientific, Technical & Medical
- Risk & Business Analytics
- Legal
- Exhibitions

Scientific, Technical & Medical provides information and analytics that help universities and professionals improve science, advance healthcare and improve performance. It helps researchers make new discoveries, collaborate with their colleagues and give them the knowledge they need to find funding. It helps governments and universities evaluate and improve their research strategies.

The business organises, reviews and publishes 18 per cent of the world's scientific articles. ScienceDirect is the world's largest scientific and medical research database with 16 million monthly users. As well as other database products, the business provides an extensive catalogue of scientific journals such as *The Lancet*.

Risk & Business Analytics provides data and analytical tools to insurance companies to help detect and prevent online fraud and money laundering. It also provides digital tools that help airlines and farmers improve their operations.

Its LexisNexis Risk Solutions business works with banks and insurance companies checking customer identities and screening transactions for signs of fraud. Its Threatmetrix ID business can help companies spot the difference between a legitimate customer and a fraudster in real time.

Accuity has information on over 22,000 banks and hosts over 600,000 financial counterparty due diligence documents. Over 95 of the world's largest 100 banks use its data.

Cirium tracks 100,000 commercial flights every day and more than 70m passenger itineraries a year, while analysing 2.5bn travel segments per annum worth about $300bn. Cirium holds data on more than 100,000 commercial aircraft.

Legal provides legal, regulatory and business information and analytics that help customers increase their productivity, improve decision-making and achieve better outcomes. Its LexisNexis legal and news database has over 109 billion documents and records which can help lawyers prepare their work and possibly help them win cases.

Exhibitions is a leading global events business. It combines face-to-face with data and digital tools to help customers learn about markets, source products and complete transactions. It hosts over 500 events in over 40 industry sectors across 30 different countries throughout the world.

I like these kind of businesses. They fit into a problem solving theme, which is common among many companies that I see as attractive investments. Its data businesses also have pricing power and are difficult to compete against. The costs involved with compiling masses of data and turning it into products means there are substantial barriers to entry here.

RELX had a solid year in 2019, with steady revenue and profits growth. Its full-year results were released on Thursday this week and pretty much matched analysts' forecasts. Underlying revenues were up by 4 per cent, with underlying operating profits up by 5 per cent.

BUSINESS AREA ANALYSIS

	Year ended 31 December				
	2019 £m	2018 £m	Change	Change at constant currencies	Underlying growth
REVENUE					
Scientific, Technical & Medical	**2,637**	2,538	+4%	+1%	+2%
Risk & Business Analytics	**2,316**	2,117	+9%	+5%	+7%
Legal	**1,652**	1,618	+2%	-1%	+2%
Exhibitions	**1,269**	1,219	+4%	+2%	+6%
Total	**7,874**	7,492	+5%	+2%	+4%
ADJUSTED OPERATING PROFIT					
Scientific, Technical & Medical	**982**	942	+4%	+2%	+3%
Risk & Business Analytics	**853**	776	+10%	+5%	+8%
Legal	**330**	320	+3%	+1%	+8%
Exhibitions	**331**	313	+6%	+4%	-1%
Unallocated items	**(5)**	(5)			
Total	**2,491**	2,346	+6%	+3%	+5%

Source: RELX

The Science, Technical & Medical (STM) business had a steady year and remains extremely profitable with profit margins of 37.2 per cent. Electronic sales continued to grow while print declined. The business made satisfactory progress by offering broader research and analytical tools to its customers and with a higher number of articles submitted to its subscription business.

However, STM is a business that I and others worry about. Perhaps it is just too profitable and it's not really surprising that the authors of the articles that end up in its journals and databases think that RELX could be making too much money out of them.

This issue raised its head in 2019 and is highlighted as a key risk to RELX's business in the notes to its annual report: "Our Scientific, Technical & Medical (STM) primary research content, like that of most of our competitors, is sold largely on a paid subscription basis. There is continued debate in government, academic and library communities, which are the principal customers for our STM content, regarding to what extent such content should be funded instead through fees charged to authors or authors' funders and/or made freely available in some form after a period following publication. Some of these methods, if widely adopted, could adversely affect our revenue from paid subscriptions."

I see this as a real risk that needs to be monitored closely. My guess is that any change is likely to take some time. RELX does not see it as an immediate threat and expects modest revenue growth and margin progression from its STM business in 2020.

The LexisNexis Risk & Analytics and Legal businesses saw good growth in profits and should also keep on growing modestly in 2020, while the Exhibitions faces some uncertainty due to the coronavirus and a lack of venues in Japan because of the Olympics.

The business remains in very rude health. Debt levels are quite high at £6.2bn, but operating profits cover the interest payments on it eight times, which is very comfortable. Its key financial performance measures show that it remains an outstanding and very profitable business.

£m	2019	2018
Revenues	7824	7492
Op Profit	2491	2346
Capital Employed	9902	10070
Free cash flow	1743	1653
Op margin	31.8%	31.3%
ROCE	25.2%	23.3%
FCF margin	22.3%	22.1%

Source: RELX & Investors Chronicle

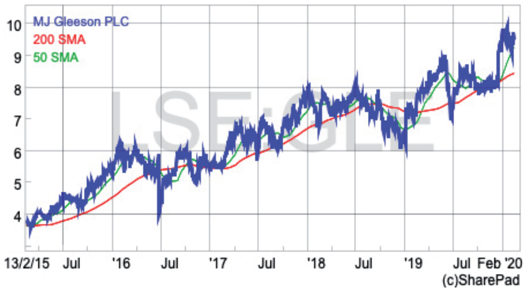
Concerns about the STM business aside, RELX looks to be well placed to keep on growing. Modest revenue growth and margin expansion combined with strong free cash flows and continued share buybacks should keep earnings per share (EPS) and dividends to shareholders ticking upwards.

RELX forecasts

	2019	(£m) 2020	2021
Turnover	7,938.10	8,206.90	8,494.90
Ebitda	2,865.30	2,992.00	3,132.50
Ebit	2,506.60	2,615.10	2,728.60
Pre-tax profit	2,269.00	2,371.40	2,518.80
Post-tax profit	1,801.60	1,868.70	1,941.40
EPS (p)	92.5	98.1	104.8
Dividend (p)	45.6	48.6	52
Capex	384.7	397	409.1
Free cash flow	1,779.40	1,889.60	1,978.90
Net borrowing	6,107.60	5,828.10	5,519.40

Source: SharePad

At 2,039p, the shares trade on a 2020 forecast PE of 20.8 times and offer a forecast dividend yield of 2.4 per cent. That looks fine to me.



MJ Gleeson

Regular readers will know that I am not a fan of housebuilders or the industry in general, but if I had to own one house-building share in the UK it would probably be **MJ Gleeson (GLE)**.

I like its strategy of targeting the more affordable end of the housing market in areas of the Midlands and the North that the big builders aren't really bothered about. Backed by the Help to Buy scheme, which supports 68 per cent of its sales, it is able to carve out a very profitable niche for itself with very little competition.

This means that it is able to keep on buying up parcels of cheap land to build more homes on at good levels of profitability.

I also like the fact that its growth strategy is based on volume – selling more – rather than rising prices. The company says that it is "comfortably" placed to meet its target of 2,000 annual sales completions by July 2022. If it does this, the shareholders can look forward to a decent period of profits growth.

Half-year results for the period to December 2019 were released on Thursday this week and were pretty solid. Gleeson sold 17.4 per cent more homes (811 units) at a slightly higher average selling price – 1.2 per cent – of £128,900. Gross margins fell back slightly due to higher build rates and a change in development mix. Operating margins on its homes fell from 15.9 per cent to 15.1 per cent.

Trading conditions for the Homes business remain strong. Reservations per site were 5 per cent higher in January than a year ago, with the company intending to expand its number of working sites from 63 currently to 70 by June. The landbank of 13,625 plots was largely unchanged on a year ago, but Gleeson has no worries in securing the land it needs to meet its volume targets,

An absence of sales from the company's strategic land business in the South of England meant that its half-year pre-tax profits were down by just over 40 per cent, but the half-year dividend per share was increased by 4.3 per cent to 12p.

The outlook for the land business in the second half of the year is looking good and could sell 1,894 plots if all the planned sales go through. Consequently, the management team remains confident of meeting current profit forecasts. The lack of a forecast upgrade was probably the reason why the shares sold off slightly on the back of the results.

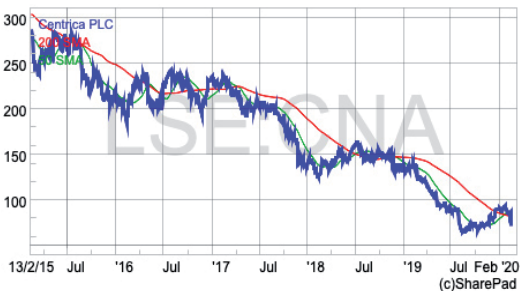
The Land business remains a significant store of value for Gleeson shareholders. It has a 77 per cent interest in 66 sites in the South of England which contain a total of 22,500 plots. Apart from a big recession and a sharp fall in house prices – which is always a risk – Gleeson should be able to generate decent amounts of incremental value over the next few years.

Ten sites with 3,384 plots have planning permission or are close to receiving it, with another nine sites in the planning process. While the timing of sales is uncertain, the business looks to be well placed.

MJ Gleeson forecasts

	2020	(£m) 2021	2022
Turnover	269.1	298.8	327.9
Ebitda	45.8	50.4	55.1
Ebit	44.7	49.3	54
Pre-tax profit	45	49.6	54.3
Post-tax profit	36.8	40.8	44.5
EPS (p)	66	72.7	79.4
Dividend (p)	36	37.6	39.3
Capex	2	2	2
Free cash flow	17	21	28
Net borrowing	-26	-25	-26.9
NAV	218	241	270

Source: SharePad



Centrica

Centrica (CNA) – the owner of British Gas – seems to have spent the past 25 years trying to work out what it wants to be. It started out trying to become a household services company and then flirted with the idea of turning itself into a gas exploration and production company and electricity generator before changing its mind again. It now wants to be a household services company again.

Years of flip-flopping, bad decisions and regulatory and competitive squeezes have piled misery on any shareholder who has hung onto their shares. Trying to predict Centrica's profits from one year to the next was nigh on in possible given the ups and downs of gas and electricity prices and the masses of contracts to buy and sell energy.

Last summer Centrica decided to bite the bullet and get out of exploration and production and sell its stake in nuclear power stations. This is undoubtedly a good decision, but one that will take time to bear any fruit.

A loss-making gas contract in Centrica's business energy division is expected to inflict losses of £100m on it in 2020 and offset any profit growth from energy supply and home services. So 2020 will see no profits growth and no debt reduction either unless assets are sold.

The big question is whether a stake in what's left – a UK and US energy supply and home services business – is worth having.

Energy supply is a badly broken business, in my view, with little long-term growth potential. No supplier has been able to consistently create a business that offers customers stable and cheap energy. Any competitive advantage has generally been temporary and based on getting hold of a cheap supply of wholesale gas or electricity, and using it to undercut the competition and win customers only to lose a chunk of them when the contract runs out and they go elsewhere.

Home Services can be a good business, but it requires significant investment in customer service. British Gas's boiler and central heating insurance plans used to be a very good business. In recent years, the company has put profit before service; it has sacked lots of engineers and outsourced boiler inspections to local, self-employed gas engineers. In doing so, it has lost a bond with the customer who increasingly has the impression that it is just a commoditised service which they can shop around for.

Yet there are grounds for optimism. The British Gas brand still has some trust left in its legacy boiler business, and from personal experience I can say that it is a better bet than going elsewhere. The Services business did see 5 per cent growth in customer numbers last year to 7.9m, which is moderately encouraging, while profit per customer went up from £40 to £58. This compares favourably with the £19 per customer made from the UK energy supply business.

Home Solutions is based around its Hive smart technology business, which allows customers to monitor and control things in their home when they are not there – such as their lights, central heating and devices. There is also a remote boiler monitoring service as well that can look out for gas leaks. This business is growing in popularity with a 33 per cent growth in customers to 1.2m last year.

I haven't got time to do the work right now, but the main problem for investors as I see it is how to value Centrica – the bits it wants to get rid of and the bits it wants to keep. It's not easy and there's lots of complicated numbers to get your head around.

That said, I do think that the main interest for investors or potential investors now in Centrica might be working out what it would be worth on a break-up scenario. Its customer base will have attractions to energy and home services companies. Based on what Ovo paid for SSE's home energy business last year – using profit or per customer multiples – gives an enterprise value for Centrica's UK Energy business of between £1.3bn and £1.7bn. The company's total enterprise value at the moment is around £9bn (of which half is debt) at a share price of 85p.

Continued....

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Centrica forecasts

	2019	(£m) 2020	2021
Turnover	28,999.20	28,930.60	28,726.00
Ebitda	2,038.50	2,063.40	1,973.30
Ebit	976.9	1,056.80	1,055.40
Pre-tax profit	718.6	835.8	825.6
Post-tax profit	413.6	532.7	574
EPS (p)	7.2	9.1	9.6
Dividend (p)	5	5.1	5.2
Capex	991	984.2	829.5
Free cash flow	713.3	642	671.5
Net borrowing	3,539.60	3,095.70	3,216.00

Source: SharePad

This is not a business that appeals to me even in a cleaned-up state. I cannot see how it can deliver meaningful levels of profits growth to make a long-term investment worthwhile. A takeover or break-up is the more likely route to profits from here, but I wouldn't bank on it happening.

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