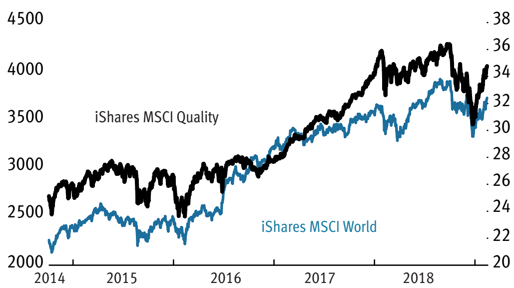
investors CHRONICLE alpha

15 February 2019

Phil Oakley's Weekly Round-Up

This week I introduce my Fantasy Sipp portfolio, which demonstrates my quality shares philosophy

Global quality factor performance



Source: Bloomberg, iShares MSCI World & iShares MSCI World Quality ETFs

Alpha Production Editor: Sameera Hai Baig

The companies mentioned this week are:

- AJ Mucklow
- AA
- Debenhams
- Smart Metering Systems

Building your own quality shares portfolio

When it comes to individual stock-picking and building a portfolio for long-term investment in a self-invested personal pension (Sipp) or an individual savings account (Isa), I favour a quality shares approach. Identifying them is the topic of my book *How to Pick Quality Shares*.

Put simply, quality shares have the following qualitative and quantitative characteristics:

1. The companies provide goods or services that are difficult for competitors to copy or they are the lowest cost operators in their field.
2. Have high profit margins – typically more than 10 per cent
3. Have high returns on capital employed – typically more than 15 per cent.
4. Turn most of their profits into cash.
5. Do not have lots of debt
6. Are not expensively valued. You have to pay up for quality, but a one-year forward rolling PE of more than 30 times is too much for me.
7. Most importantly, are capable of further sales, profit and cash flow growth.

By investing in quality businesses and not paying too much for them, it is hoped that a portfolio of shares will

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produce satisfactory returns over time, with the aim of doing better than investing in a cheap tracker fund. The last bit is not easy.

Below is a portfolio of quality UK and US shares that I have been running for just over a year. I believe most of the shares meet all of the criteria mentioned above.

Phil Oakley's quality shares portfolio, as of 13/2/2019

Name	Market cap (m)	Close	ROCE	EBIT margin	PE roll 1	fc Yield	% chg 31/12/18
Visa Inc	321,555.6	14,201	22.8	65.1	25.2	0.7	8.68
Unilever PLC	176,261.9	4,260.5	27.7	25.4	19.1	3.4	3.7
Walt Disney Co (The)	162,792.8	10,916	18.5	25	15	1.6	-0.105
Pepsico Inc	160,622.3	11,379	17.2	16.9	19.3	3.1	3.06
McDonalds Corp	134,115.3	17,390	18.2	41.5	20.9	2.7	-2.07
3M Co	118,943	20,653	23.5	20.8	19.1	2.8	8.89
Diageo PLC	73,101.1	3,024	16.3	34	22.9	2.3	8.19
British American Tobacco	64,523.8	2,813	37.7	151.4	8.8	7	12.5
RELX	33,901.8	1,726	21	26	19	2.4	6.77
Moody's Corp	31,259.5	16,315	41.9	43.9	20.7	1.1	17.2
Paychex Inc	26,870.8	7,483	60.7	38.5	24.8	3	15.1
London Stock Exchange Group	16,148.1	4,638	10.5	34.4	23.4	1.3	14.2
Intertek Group PLC	8,382.8	5,194	20.5	15.7	24.4	1.8	8.21
InterContinental Hotels Group	8,256	4,555.5	40.9	42.8	17.8	2.1	2.14
Hargreaves Lansdown	7,854.7	1,656	77.2	64	28.1	2.6	-10.4
Sage Group (The)	7,111.6	655	18	25	21.1	2.5	8.91
Croda International	6,748	5,126	24	23.8	24.8	1.7	9.41
Halma PLC	5,675.7	1,495	13.8	16.7	27.1	1.1	9.6
Spirax-Sarco Engineering	4,865.8	6,610	19.1	20.1	24.9	1.5	5.93
James Halstead	1,053.4	470	29.9	19	24.4	3.1	10.1
Avon Rubber	397.1	1,280	18.1	14.4	16.7	1.6	2.4

Source: SharePad

I must make two things very clear. First, the shares in this portfolio are not recommendations to buy them, but to be used as an illustration of my preferred stock-picking approach. I set up this portfolio just over a year ago to run my Sipp.

Second, as writers for the *Investors Chronicle* are not allowed to own shares that they write on, I no longer own this portfolio. However, I have kept on managing it as a fantasy Sipp portfolio as if it was still my real Sipp. Since I joined the IC in August 2018, I have added Avon Rubber and McDonald's to the portfolio.

This is a portfolio of UK and US shares. I believe it is very difficult to put together a diversified portfolio of UK quality shares. The US is home to many of the world's best companies and many UK brokers make it relatively easy to buy and sell US shares.

The portfolio was initially equally weighted in 20 different shares. It currently has 21 shares weighted as follows:

Name	%
Unilever	5.7
InterContinental Hotels Group	5.4
Diageo	5.4
Croda International	5.3
Spirax-Sarco Engineering	5.2
Pepsico Inc	5.2
Paychex Inc	5.1
Visa Inc	5.1
RELX	5.1
London Stock Exchange Group	5.0
Walt Disney Co (The)	4.9
3M Co	4.8
Halma	4.7
Sage Group (The)	4.7
McDonalds Corporation	4.7
James Halstead	4.7
Moody's Corporation	4.4
British American Tobacco	4.3
Intertek Group	4.2
Hargreaves Lansdown	3.6
Avon Rubber	2.5

Source: SharePad, as of 13/2/2019

The aim is to compare this portfolio's performance against the following quality investment funds, the FTSE All-Share index and a S&P 500 tracker fund:

- Fundsmith Equity
- Finsbury Growth & Income Trust
- Lindsell Train Global Funds
- Castlefield UK Buffettology
- Scottish Mortgage Trust

These funds are run by very talented people with very good long-term track records. Over one year and year to date, my model portfolio has done quite well, but sticking your money in a S&P 500 tracker fund without having to go through all the research and stock-picking has been a very good home for your money and shows you how difficult it is to beat the markets.

Name	%TR 31/12/18	%TR 1-yr
Vanguard S&P 500 ETF	9.19	12.2
Fundsmith Equity T Acc	8.85	14.8
Finsbury Growth & Income Trust PLC	7.44	13.5
Phil Oakley Quality Shares	**7.2**	**13**
FTSE All-Share – Total Return	7.14	3.85
Scottish Mortgage Investment Trust PLC	6.99	14
Lindsell Train Global Funds – Lindsell Train Global Equity Fund D GBP Inc	6.62	20.4
Castlefield CFP SDL UK Buffettology Fund General Income Shares	3.19	9.11

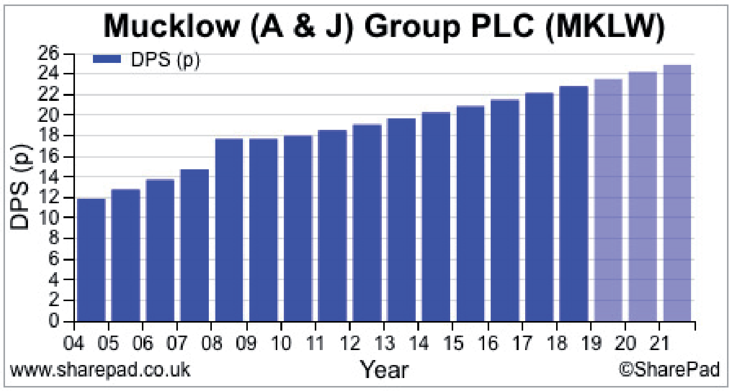
Source: SharePad

This model portfolio is aimed at practicing inactivity and is not intended to change much. I will provide an update in every week's newsletter with comments as necessary. I hope you find it interesting.

AJ Mucklow

Investing in real-estate investment trusts (Reits) can be a good strategy for income investors. Managed well and with a decent market backdrop, Reits can provide a reliable and modestly growing source of dividend income, as the company has to pay out most of its income to shareholders.

AJ Mucklow (MKLW), a Midlands-based owner of predominantly industrial properties has done a good job in this respect over the years. The Mucklow family remains the largest shareholder with Rupert Mucklow in the position of chairman.



Source: SharePad

Half-year results released this week reported another steady performance from the business. Occupancy levels of its properties reached a record high of 97.6 per cent, which helped to increase the gross rental income by £0.5m to £12.5m and pre-tax profits from £8m to £8.5m. The half-year dividend was increased by 2.9 per cent to 10.48p per share.

Seventy per cent of the company's property portfolio (circa £300m) is invested in industrial warehousing and logistics properties. Despite concerns about the UK leaving the EU without a deal, the rental demand for these properties remains robust.

The company is investing in a new development called Mucklow Park near Birmingham, which should bring in an extra £1m of annual rental income. The prospects for further rental income growth from the existing estate look reasonable as the company is achieving higher rents on new lettings and from regular rent reviews.

Mucklow (A & J) Group PLC (MKLW)

FORECASTS — £ millions unless stated

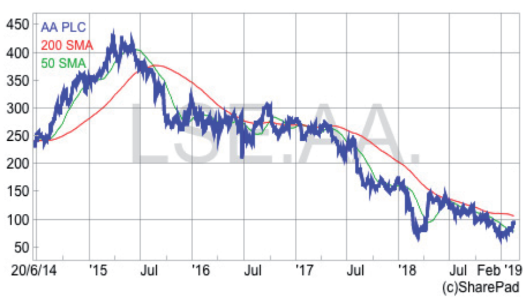
Year	2019		2020		2021	
Turnover	25.5	+1.6%	25.9	+1.8%	-	
EBITDA	20.2	-73.5%	20.6	+1.6%	-	
EBIT	20.0	-73.8%	20.3	+1.8%	20.5	+0.9%
Pre-tax profit	17.2	-76.5%	17.4	+1.5%	17.4	-0.2%
Post-tax profit	24.1	+52.2%	24.5	+1.9%	32.1	+31.0%
EPS (p)	27.2	+8.4%	27.5	+1.1%	27.5	0.0%
Dividend (p)	23.5	+3.2%	24.2	+3.0%	24.9	+2.9%
CAPEX	6.0		3.0	-50.0%	-	
Free cash flow	-		-		-	
Net borrowing	71.9	+1.2%	73.3	+2.0%	77.2	+5.3%
NAV	370.6	+5.2%	387.1	+4.5%	403.7	+4.3%

Source: SharePad

This company is exposed to the fortunes of the industrial economy and therefore does come with a reasonable degree of risk. To counter this, it is managed well with very little debt compared with other Reits. Net borrowings of £69m is a very modest 16 per cent of the property portfolio's value of £443m.

The portfolio's value has nudged up by £8.7m between June and December 2018 and has an initial yield of 5.8 per cent and an equivalent yield (which takes into account future rent cash flows) of 6.3 per cent. The net asset value (NAV) is £361.8m or 572p per share.

At the time of writing, the share price was 495p or a 13.5 per cent discount to NAV. I understand why investors might be nervous about this company given the political environment at the moment. However, taking this into account and the 4.7 per cent dividend yield, I see Mucklow as a conservative, well-managed business that might interest income-seekers.



AA

For me, **AA's (AA.)** problems are very simple. It cannot grow its business and it has too much debt.

That said, the shares have made a strong start to 2019 and are up by 28 per cent so far. They also trade on a one-year rolling forecast PE of just six times (explained to an extent by its very high debts) and will undoubtedly be a focus for value investors looking for a positive catalyst to improve the company's fortunes.

This week's full-year trading update has gone down well with investors, with earnings before interest, tax, depreciation and amortization (Ebitda) for the year to January 2019 expected to be slightly ahead of analysts' consensus forecasts at £340m.

AA is essentially an insurance business. The bulk of its revenues come from its AA breakdown cover service. Within this, more than three-quarters of the business is accounted for by breakdown cover provided to car manufacturers and commercial vehicle fleets.

This part of the business seems to be holding up well. Its key customer contracts with manufacturers have been retained for 2019, while a new three-year contract with fleet and leasing company Arval has been won. Average revenue per customer increased by a decent 5 per cent, which will be helpful in terms of maintaining and growing profits.

The personal breakdown business continues to face very tough competition, with membership falling by 2 per cent. It seems that there is not much scope for meaningfully growing this business over the few years.

Motor insurance has had a good year with 16 per cent growth in policies and home insurance policies growing by 1.5 per cent. Insurance underwriting also seems to have performed well.

But where does AA go from here?

AA PLC (AA.)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	964.2	+0.4%	973.0	+0.9%	995.9	+2.4%
EBITDA	334.5	-1.9%	345.9	+3.4%	359.0	+3.8%
EBIT	262.2	-3.3%	259.3	-1.1%	271.6	+4.7%
Pre-tax profit	107.0	-23.0%	115.7	+8.2%	129.3	+11.8%
Post-tax profit	90.5	-31.9%	95.8	+5.8%	104.2	+8.7%
EPS (p)	14.6	-33.0%	15.2	+4.1%	17.3	+13.8%
Dividend (p)	2.0	-60.0%	2.0	0.0%	2.0	0.0%
CAPEX	95.0	+50.8%	71.5	-24.7%	71.0	-0.7%
Free cash flow	86.3	-23.7%	124.6	+44.4%	139.2	+11.8%
Net borrowing	2,718.1	+1.8%	2,629.5	-3.3%	2,526.5	-3.9%

Source: SharePad

It has a good brand but operates in fiercely price-competitive markets. I struggle to see how this is a business that can meaningfully grow in the years ahead.

Debt remains stubbornly high at an eye-watering 8.1 times Ebitda and doesn't look like coming down much in the years ahead. This is a company that has changed hands amongst corporate owners many times in the past, but the debt pile will surely put off any potential buyer which takes away a takeover as a source of further upside.

Debenhams

As far as shareholders are concerned, most people think that **Debenhams (DEB)** is close to the end. It's very difficult to see it as a "cigar butt" share that has one last puff in it before being extinguished.

Declining like-for-like sales are commonplace across Britain's high streets, but when you have nearly £300m debt and have signed up to very long rent agreements on your shops, it can kill a business.

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This week Debenhams has been given a £40m lifeline by its lenders and a waiver on covenants relating to its revolving credit facility. The company probably needed this money because its suppliers were unable to get credit insurance. This new loan buys the company some time and gives suppliers some assurance that it can pay its bills for a while yet.

The company has also entered into a sourcing arrangement with Li & Fung, a leading supply chain company in the hope of improving the sourcing of its own-label products in order to make better profit margins from them.

Debenhams PLC (DEB)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	2,821.9	+23.9%	2,768.3	-1.9%	2,715.9	-1.9%
EBITDA	134.4	-14.6%	135.7	+1.0%	135.7	-0.0%
EBIT	25.4		21.8	-14.2%	23.9	+9.6%
Pre-tax profit	12.9		11.7	-9.3%	13.9	+18.8%
Post-tax profit	11.8	-57.7%	9.1	-23.2%	9.9	+9.7%
EPS (p)	0.9	-59.1%	0.7	-22.2%	0.9	+28.6%
Dividend (p)	-		-		-	
CAPEX	72.2	-46.9%	75.2	+4.2%	75.0	-0.3%
Free cash flow	39.8		46.9	+17.8%	44.6	-4.9%
Net borrowing	289.7	-9.8%	254.3	-12.2%	216.3	-15.0%
NAV	507.0	+3.6%	503.0	-0.8%	-	
Like for like sales growth %	-1.0		1.1		1.8	+63.6%

Source: SharePad

This is a welcome development, but it's hard to see how Debenhams' current situation ends well for shareholders.

I think it's possible that the company survives in some form with a lot fewer stores. The problem for shareholders is that this week's lifeline is just buying the company time before it has to sort out its finances properly. I could be wrong, but this probably involves the company's lenders accepting some form of debt for equity swap, which all but wipes out existing shareholders.

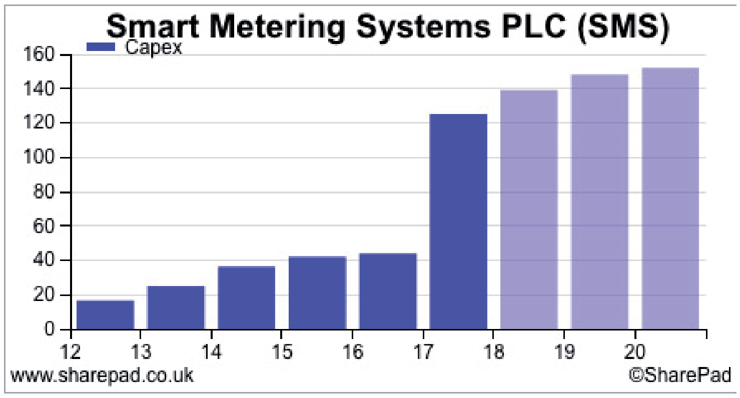
Smart Metering Systems

Smart Metering Systems (SMS) has been in business since 1995. The company's roots were established following the deregulation of the domestic gas meter market. Today the company makes its money from three different sources:

1. Installing gas and electricity meters for business and household customers.
2. Managing gas and electricity meter assets for energy suppliers. Here the company receives rent from customers for the use of the meter and for providing them with data from it over the life of the meter. Meters can have working lives of up to 25 years, which means that the rent could be extremely valuable.

3. Energy management – helping businesses to reduce their energy consumption and carbon footprint.

The bull case for this stock is that it spends a lot of money in the next few years buying and installing metres and gets many years of predictable, low-risk free cash flows in the future. As you can see, capex spending has been increasing significantly in recent years and is expected to stay high



Source: SharePad

Free cash flow is expected to stay negative. But SMS is rapidly building up a portfolio of installed meters and a level of dependable annualised income from them.

Year	No. of meters	Annualised income (£m)	Income per meter
2011	254,000	6.6	£25.98
2012	341,000	9.3	£27.27
2013	469,000	18.3	£39.02
2014	769,000	26.2	£34.07
2015	979,000	34.7	£35.44
2016	1,251,000	41.3	£33.01
2017	2,030,000	57	£28.07
2018	3,130,000	75.3	£24.05

Source: Company reports

In 2018, the number of installed meters increased by 54 per cent to 3.13m, with the number of smart meters doubling to 846,000. The level of annualised recurring revenues from the portfolio increased by 32.3 per cent to £75.3m.

Smart Metering Systems PLC (SMS)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	95.2	+19.6%	111.3	+17.0%	125.8	+12.9%
EBITDA	50.6	+37.2%	71.7	+41.6%	91.8	+28.1%
EBIT	27.6	+21.8%	41.8	+51.8%	55.0	+31.5%
Pre-tax profit	24.6	+33.1%	32.9	+33.8%	40.6	+23.2%
Post-tax profit	21.6	+19.5%	29.4	+35.9%	36.6	+24.7%
EPS (p)	18.5	-5.6%	25.1	+35.7%	30.6	+21.9%
Dividend (p)	5.7	+9.6%	7.2	+26.3%	10.2	+41.7%
CAPEX	139.1	+11.0%	148.1	+6.5%	152.1	+2.7%
Free cash flow	-91.6		-87.2		-76.6	
Net borrowing	148.1	+305.9%	249.4	+68.4%	337.0	+35.1%

Source: SharePad

The revenues from the meter rental business are very profitable, with cash margins (excluding depreciation) approaching 90 per cent. Assuming that the meters last 25 years, it is possible to build a very bullish case for SMS shares.

The company is targeting independent energy suppliers and has agreements with 10 of them with the potential to convert up to 5m meters to smart meters. The company is eventually targeting an installed base of 9m meters. At the current per meter run rate of £24, that would give annual recurring revenues of £216m and gross cash flows of £194.4m assuming a cash margin of 89 per cent. The forecast for 2019 Ebitda is £71.7m.

Yet, getting to this position may take a long time. The government wants to have 80 per cent of UK households fitted with a smart meter by 2020, but this looks way too optimistic given that only around 13m have been installed, leaving 40m still to go.

I have a smart meter at my house and am totally underwhelmed by it. The only advantage is that I do not have to send meter readings to my energy supplier. I do not feel that it helps to save energy. The big drawback is that apparently different energy suppliers have installed different types of smart meters, which makes switching suppliers and keeping the functionality of the smart meter difficult.

Smart meters are not compulsory either. The lack of any real benefits to many consumers may mean that SMS takes a long time to reach its target or doesn't meet it at all.

The shares have been popular so far in 2019 and are up by 18.5 per cent. The outlook for profits growth is bullish, which explains the high one-year forecast rolling PE ratio of 24 times at a share price of 621p.

Along with a slow meter roll-out, the big risk I see with this company is that shareholders will be asked for more equity to fund growth as was the case last year.

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