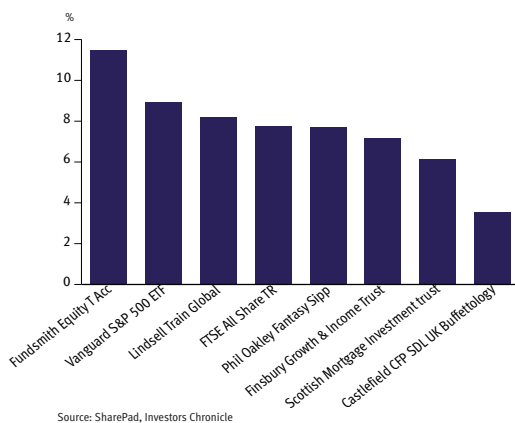




Phil Oakley's Weekly Round-Up

In this week's shares round-up I look at some companies that have been quality stalwarts in the past, but now face operational issues. I also review a couple of interesting income cases

Year-to-date total returns



The companies mentioned this week are:

- Domino's Pizza
- Dignity
- Morrisons
- Marshalls Motor Holdings
- Stobart Group

I've not much to say on the portfolio this week. On a one-year view it is doing alright. On a year-to-date basis, it is underperforming the FTSE All-Share and a S&P 500 tracker fund.

Fantasy Sipp update

Name	1-month	Year-to-date	1-year
Fundsmith Equity T Acc	0.527	11.5	13.7
Vanguard S&P 500 ETF	-0.436	8.93	7.9
Lindsell Train Global Funds	-0.218	8.18	18.1
FTSE All-Share - Total Return	0.366	7.78	3.64
Phil Oakley Fantasy Sipp	0.2	7.7	12
Finsbury Growth & Income Trust	-0.37	7.17	9.64
Scottish Mortgage Investment Trust	-0.681	6.14	5.65
Castlefield CFP SDL UK Buffettology Fund	-0.172	3.54	3.51

Source: SharePad

Alpha Production Editor: Sameera Hai Baig



Domino's Pizza

I think **Domino's Pizza UK (DOM)** is a very good business. It has a great brand that has successfully tapped into the growth in demand for takeaway pizzas. As a result, it has become very profitable.

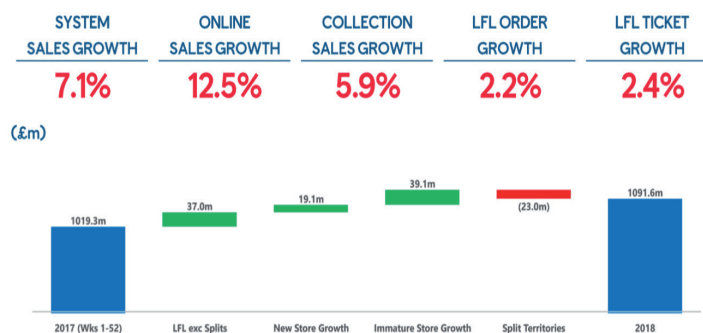
Over the past couple of years, its share price has drifted downwards as investors have questioned its growth strategy. It's fair to say that Domino's UK strategy is a little bit out of its own control. It has to pay royalty fees back to Domino's Inc in the USA, which wants to see a growing income stream in return for granting Domino's the master franchise in the UK and Ireland.

This has left Domino's with a problem. Its plan to get to 1,600 stores – from just over 1,100 now – in the UK can only be achieved by splitting sales territories between existing and new stores. This is making some of its franchisees unhappy as the new stores are taking sales and profits from existing ones – a process known as cannibalisation. At the same time, franchisees are battling with higher staff and ingredients costs, while paying nearly 10 per cent of their turnover back to Domino's in royalties and advertising fund contributions.

The big risk for Domino's is that its business can only be as strong as the health of its franchisees. If franchisees cannot make a decent return on the £300,000 average cost of setting up a new store, they will not want to open more of them. This means that they will not sell more pizzas and buy more ingredients, from which Domino's makes up virtually all of its profits.

This seems to be happening as not only has the growth in new store openings come down, but Domino's cannot be sure how many it will open in the UK in 2019.

The chart below shows that Domino's store portfolio lost £23m of sales from splitting territories last year, the figure was £21.4m the year before. The good news is that the growth in sales from immature stores remains very good and has been accelerating, while like-for-like (LFL) sales, excluding splits, grew by a reasonable 4.6 per cent.



Source: Company presentation

The table below shows how Domino's UK system sales (the sales of all its stores) have progressed since 2013. Sales per average store have held up quite well.

UK system sales (£m)	2018	2017	2016	2015	2014	2013
Previous year	1019.3	938.7	825	706.4	608.8	543
Mature stores	37	38	79.1	81.1	67.2	37.3
New stores	19.1	32	26	19	9.2	8.4
Immature stores	39.1	32	27.7	19.3	21.1	20.1
Effect of splits	-23	-21.4	-18.3	0	0	0
Closed stores	0	0	-0.7	-0.8	0	0
Total system sales	1091.5	1019.3	938.8	825	706.3	608.8
LFL ex splits %	4.6	4.8	9.8	11.7	11.3	7
UK stores	1103	1045	950	869	813	777
Net new stores	58	95	81	56	36	50
Average stores	1074	998	910	841	795	752
Sales per Avg store	1.02	1.02	1.03	0.98	0.89	0.81
Sales per week £'000	19.54	19.65	19.85	18.86	17.09	15.57

Source: Company report

Domino's has been quite honest in acknowledging that some of its franchisees are taking a hit from its split territories strategy. To help them, it is offering incentives to open new stores and is looking to reduce the upfront cost of new store investment to between £190,000 and £220,000. While average store earnings before interest, tax, depreciation and amortisation (Ebitda) fell by 3.5 per cent to £132,000 last year, the return on investment for franchisees still looks to be reasonably attractive, according to Domino's figures.

Yet, helping franchisees cost Domino's £3.4m last year:

This help is likely to have to continue for a good few years and will be a drag on profits.

Domino's UK profits

UK & ROI profit (£m)	2018	H218	H1 18	2017	H2 17	H1 17	2016	2015	2014	2013
System sales	1155.4	590.3	565.1	1079.4	556.7	522.7	988.8	865.6	748.2	650.9
Revenue	439.5	227.1	212.4	393.4	205.9	187.5	345.1	305.1	279.1	250.7
Supply chain revenue	323.5	166.8	156.7	297.4	153.8	143.6	265.1	241.0	221.8	199.7
Franchisee royalties	63.5	32.5	31.1	59.4	30.6	28.7	54.4	47.6	41.2	35.8
Royalty paid to DP Inc	31.2	46.5	-15.3	-29.1	-15.0	-14.1	-26.7	-23.4	-20.2	-17.6
Supply chain margin	94.9	49.4	45.5	87.6	44.5	43.1	83.3	71.3	60.8	54.6
Net overheads & depreciation	-30.1	-14.9	-15.2	-27.6	-13.2	-14.4	-26.5	-22.7	-18.9	-17.8
Corporate store profits	2.2	1.6	0.6	0.6	0.6	0.0	0.0	0.0	0.0	0.0
UK JV's & Assocs profit	1.7	0.2	1.5	2.4	1.2	1.2	2.1	1.7	1.0	0.6
Total UK & ROI operating profit	101.1	52.8	48.2	93.2	48.7	44.5	86.6	74.5	63.8	55.6
Op profit as % of system sales	8.7%	8.9%	8.5%	8.6%	8.7%	8.5%	8.8%	8.6%	8.5%	8.5%
Op profit as % of revenue	23.0%	23.3%	22.7%	23.7%	23.6%	23.8%	25.1%	24.4%	22.9%	22.2%
Supply chain as % of revenue	73.6%	73.4%	73.8%	75.6%	74.7%	76.6%	76.8%	79.0%	79.5%	79.6%
Supply chain % margin	29.3%	29.6%	29.0%	29.5%	28.9%	30.0%	31.4%	29.6%	27.4%	27.3%

£m	2018	H218	H1 18	2017	H2 17	H1 17	2016	2015	2014	2013
Franchise royalties	63.5	32.5	31.1	59.4	30.6	28.7	54.4	47.6	41.2	35.8
Royalty paid to DP Inc	-31.2	-15.9	-15.3	-29.1	-15.0	-14.1	-26.7	-23.4	-20.2	-17.6
Net royalty income	32.3	16.5	15.8	30.2	15.6	14.6	27.7	24.2	20.9	18.2
Net overheads & depreciation	30.1	14.9	15.2	27.6	13.2	14.4	26.5	22.7	18.9	17.8
Difference	2.2	1.6	0.6	2.6	2.4	0.2	1.2	1.5	2.0	0.4
Supply chain margin	94.9	49.4	45.5	87.6	44.5	43.1	83.3	71.3	60.8	54.6
Total UK & ROI operating profit	101.1	52.8	48.2	93.2	48.7	44.5	86.6	74.5	63.8	55.6
Supply chain as % of Op profit	93.9%	93.5%	94.4%	94.0%	91.4%	96.8%	96.2%	95.7%	95.2%	98.2%

Source: Company reports

Domino's UK profits grew quite nicely in 2018 almost entirely from selling ingredients to its franchisees – the supply chain margin. Its profit margin from this source is very high at 29.3 per cent and may be a further cause for grumbling amongst franchisees who think that Domino's is making too much money from them.

The overseas business had a terrible year and lost £4.1m. The value of investments in its businesses in Sweden, Norway and Switzerland were written down in value to reflect their reduced outlook for future profits.

Higher interest costs meant that pre-tax profits fell slightly.

Domino's Pizza Group PLC (DOM)						
FORECASTS						
£ millions unless stated						
Year	2018		2019		2020	
Turnover	545.3	+21.1%	583.6	+7.0%	631.8	+8.3%
EBITDA	111.0	+13.6%	118.8	+7.0%	127.6	+7.5%
EBIT	95.8	+23.9%	102.8	+7.3%	111.0	+8.0%
Pre-tax profit	94.2	+25.0%	99.7	+5.8%	108.6	+8.9%
Post-tax profit	77.2	-1.9%	80.7	+4.5%	87.0	+7.8%
EPS (p)	16.0	+1.3%	16.9	+5.6%	18.9	+11.8%
Dividend (p)	9.6	+6.7%	10.4	+8.3%	11.2	+7.7%
CAPEX	32.7	-24.7%	25.2	-23.0%	28.0	+11.3%
Free cash flow	60.5	+20.6%	84.7	+40.0%	84.3	-0.5%
Net borrowing	203.5	+114.7%	220.5	+8.3%	164.7	-25.3%
NAV	5.4	-87.7%	42.1	+679.6%	85.3	+102.6%
Like for like sales growth %	4.8		4.2	-11.6%	5.2	+23.8%

Source: SharePad



Forecasts for 2019 look to be achievable if the overseas business achieves a breakeven result this year. At 231p, this would equate to a forward PE of 13.7 times, which does not look too expensive. The problem is the continued uncertainty over the splitting strategy, the costs of it and the impact on store openings. If these can be resolved then Domino's shares can move higher. This might take some time though.

Dignity

Up until a couple of years ago, I would have said that funeral services provider **Dignity (DTY)** was an example of a very good business. I had my eyes opened to it when I did a detailed analysis of the company in my previous job and was shocked to see how aggressive its pricing strategy had been with significant hikes in average revenue per funeral over many years.

Pricing power is usually seen as a desirable characteristic of a potential investment. When it possibly comes from fleecing its customers, it is not. High prices and fat profit margins usually attract competition, and Dignity has experienced this. In cutting prices to make its services more attractive it has taken a hit to its profits.

The company has significantly cut the price of simple funerals and it has led to a big increase in the proportion of the revenue mix they account for, which has dragged down average revenue per funeral by 7.7 per cent to £2973.

Funeral type		FY 2017 Actual	Board's original expectation*	H1 2018 Actual	Q4 2018 Actual	FY 2018 Actual
Average revenue (£)	Full service	3,800	3,800	3,800	3,590	3,735
	Simple and Limited service	2,700	1,965	2,240	2,435	2,350
	Pre-need	1,650	1,650	1,680	1,750	1,705
	Other (including Simplicity)	500	500	560	610	570
Volume mix (%)	Full service	60	44	52	43	48
	Simple and Limited service	7	20	15	24	19
	Pre-need	27	30	27	27	27
	Other (including Simplicity)	6	6	6	6	6
Weighted average (£)		2,945	2,590	2,799	2,637	2,734
Ancillary revenue (£)		277	280	224	260	239
Average revenue (£)		3,222	2,870	3,023	2,897	2,973

Source: Company report

Despite a higher number of deaths, more families choosing the cheaper option saw revenues fall by 3 per cent, but the company's high fixed costs and big operational gearing saw operating profits fall by 23 per cent. A significant amount of financial gearing saw earnings per share fall by 33 per cent.

The damage is not over yet, despite the company's efforts to become more efficient. Another hefty fall in profits is expected in 2019. I am not convinced that profits will start recovering in 2020.

Dignity's profit margins fell from 32.2 per cent to 25 per cent in 2018 and are expected to fall further to just over 20 per cent in 2019. They might still fall further.

The Competition and Markets Authority (CMA) and the government are looking at the funeral market and the market for pre-paid funerals from which Dignity has a significant amount of deferred revenue.

Funerals are incredibly expensive and the general public is becoming more aware of this. Competition is driving down prices and there is a chance that regulation of the sector might push profits down further.

My view is that simpler, cheaper funerals will continue to grow at the expense of full service ones as people become more informed. The risks to Dignity's profits may still have a way to run. The shares look inexpensive on a forward PE of 10.6 times but I see that rating as a reasonable reflection of the risks that face the company.

Dignity PLC (DTY)

FORECASTS

£ millions unless stated

Year	2018	2019	2020
Turnover	318.1 -1.8%	310.7 -2.3%	312.3 +0.5%
EBITDA	96.8 -17.1%	87.4 -9.7%	88.7 +1.5%
EBIT	78.7 -19.6%	68.7 -12.8%	70.4 +2.4%
Pre-tax profit	52.8 -25.9%	43.3 -18.0%	44.3 +2.4%
Post-tax profit	42.1 -34.3%	34.2 -18.6%	35.8 +4.6%
EPS (p)	84.2 -34.4%	68.8 -18.3%	70.6 +2.6%
Dividend (p)	24.4 +0.1%	24.4 0.0%	24.4 0.0%
CAPEX	22.0 -18.5%	21.7 -1.5%	21.7 0.0%
Free cash flow	37.3 -26.7%	27.2 -27.2%	29.4 +8.1%
Net borrowing	498.1 -3.6%	486.6 -2.3%	473.1 -2.8%

Source: SharePad



Morrisons

I am not a fan of supermarkets as investments. They operate on wafer thin profit margins and have very poor returns on capital employed (ROCE). This is a result of fierce competition in the sector and the case of too many supermarkets chasing too few shoppers.

Asda and Sainsbury's are struggling and see getting together as a way of getting out of trouble. Tesco and **Morrisons (MRW)** are faring slightly better in engaging with customers, serving them better and making more money. As I have written recently, both companies are interesting for income investors because of their growing dividend payouts.

This week's results from Morrisons suggest that this investment case is alive and well. LFL sales continue to grow as its strategy continues to bear fruit. Its core super-

markets business is performing well and its wholesale food business is building up nicely.

ROCE remains poor at 7.9 per cent, although profit margins have improved slightly to a still thin 2.62 per cent. The real strength of the business remains strong free cash generation which increased from £256m to £262m. This is allowing Morrisons to grow its annual dividend by 8.3 per cent and pay a special dividend of 6p on top of a 4p payment last year.

As profitability continues to improve, the wholesale business continues to grow and the company holds back from opening lots of new supermarkets, the outlook for free cash flow growth looks to be reasonable.

In two years' time, the shares at 225p offer a prospective yield of 4.6 per cent with the prospect of further dividend growth. This remains a strong attraction for owning the shares.

Morrison (Wm) Supermarkets PLC (MRW)

FORECASTS						
£ millions unless stated						
Year	2019		2020		2021	
Turnover	17,847.3	+3.4%	18,388.2	+3.0%	18,820.9	+2.4%
EBITDA	906.5	+6.6%	948.5	+4.6%	980.4	+3.4%
EBIT	467.7	+8.3%	496.1	+6.1%	519.6	+4.7%
Pre-tax profit	403.4	+9.6%	442.5	+9.7%	470.9	+6.4%
Post-tax profit	309.0	+8.4%	335.6	+8.6%	361.1	+7.6%
EPS (p)	13.0	+9.2%	14.1	+8.5%	15.1	+7.1%
Dividend (p)	8.8	+44.5%	9.3	+5.7%	10.3	+10.8%
CAPEX	488.3	-2.3%	480.4	-1.6%	493.6	+2.7%
Free cash flow	298.3	+16.5%	379.9	+27.3%	396.7	+4.4%
Net borrowing	932.8	-6.6%	816.2	-12.5%	705.3	-13.6%
NAV	4,831.0	+6.3%	4,928.0	+2.0%	4,954.0	+0.5%
Like for like sales growth %	1.4		1.3	-10.7%	1.4	+12.0%

Source: SharePad



Forterra

My views on housebuilders should be well known to regular readers. I am more upbeat on the makers of bricks, blocks and concrete products such as **Forterra (FORT)**. Yes, they are a cyclical business but they do not face the same selling price risks as builders do. The cost of bricks only accounts for around 1 per cent of the selling price of a house,

Forterra has a very strong position in the UK bricks and blocks market and remains supported by very strong fundamentals of:

- Growing supply of new-build homes in an under-supplied market – 65 per cent of Forterra's sales.
- Low stock levels of bricks in the UK market.
- Investment in domestic production of brick-making facilities to replace imported supplies that have been used in recent years.

- Fifty million tonnes of owned clay reserves which give it 30 years of supply at current production rates.
- A stable repairs and maintenance market – 30 per cent of Forterra's sales.

This is married up with Forterra's ability to produce very attractive financial performance on various measures in 2018:

- Operating margins of 18.3 per cent
- ROCE of 32.1 per cent
- Free cash flow margins of 15.6 per cent
- Net debt to Ebitda of 0.5 times

Forterra PLC (FORT)

FORECASTS £ millions unless stated

Year	2018		2019		2020	
Turnover	360.6	+8.9%	384.5	+6.6%	394.6	+2.6%
EBITDA	77.5	+2.8%	83.5	+7.8%	85.7	+2.6%
EBIT	65.7	+5.5%	70.2	+6.8%	71.9	+2.4%
Pre-tax profit	62.7	+6.5%	67.3	+7.4%	69.5	+3.3%
Post-tax profit	51.3	+8.6%	54.2	+5.8%	56.1	+3.5%
EPS (p)	25.1	+8.2%	27.3	+8.8%	28.9	+5.9%
Dividend (p)	10.3	+8.4%	11.1	+7.8%	11.5	+3.6%
CAPEX	17.9	+65.4%	45.2	+153.2%	27.6	-39.1%
Free cash flow	47.5	-29.0%	31.3	-34.1%	46.0	+47.1%
Net borrowing	40.4	-33.5%	49.5	+22.5%	28.4	-42.7%

Source: SharePad

Forterra shares are up by 30 per cent in 2019 after a difficult 2018 due mainly to internal issues. At 290p, they trade on a 2019 forecast PE of 10.6 times. With the new build market remaining supported until 2023, Forterra looks well placed to keep on chugging away with steady growth for the next few years. The repairs and maintenance market looks strong now but needs to be watched for signs of weakness. The shares still look decent value to me.

Marshall's Motor Holdings

The new car market in the UK is going through a very rough patch. Many reasons are cited for this from a shortage of vehicles due to new emissions and the decline of diesel, as well as uncertainty caused by the UK leaving the EU.

One reason that I rarely hear is credit. The new car market has been flooded with easy credit through personal contract plans (PCPs), where people who otherwise couldn't afford to drive a brand new car can. Around nine out of 10 new cars are sold on PCPs.

PCPs can be very expensive and unaffordable for some. The monthly fee consists of the large amounts of depreciation that new cars incur over three years (they lose 50-60 per cent of their value), as well as interest on the amount



of credit given. The penalties for exceeding mileage limits are high, while at the end of the PCP the driver often has to hand the car back and enter into a new agreement, often with a large deposit.

I am not really surprised that new car sales are falling, but actually that is not a disaster for franchised car dealers, who make much better profit margins on used car sales and aftersales.

With **Marshall's (MMH)**, we can see that the fall in new car sales has been compensated by a rise in used car and aftersales, with gross profits broadly unchanged.

Like-for-Like Segmental Analysis

Twelve months ended 31 December 2018

	Revenue		Gross Profit	
	£m	mix*	£m	mix
New Car	1,045.4	48.0%	75.0	30.0%
Used Car	893.1	41.0%	65.4	26.1%
Aftersales	240.5	11.0%	109.8	43.9%
Internal/Other	(44.3)	—	0.3	—
Total	2,134.6	100.0%	250.5	100.0%

Twelve months ended 31 December 2017

	Revenue		Gross Profit	
	£m	mix*	£m	mix
New Car	1,094.8	50.8%	82.3	32.8%
Used Car	826.5	38.3%	57.9	23.1%
Aftersales	234.9	10.9%	110.7	44.1%
Internal/Other	(47.3)	—	0.3	—
Total	2,108.9	100.0%	251.1	100.0%

Source: Company report

This shows that car dealerships can weather storms quite well in the short-term. Good cost control helped Marshall's eek out a very small increase in operating profit.

CONSOLIDATED CASH FLOW STATEMENT

For the year ended 31 December 2018

	Note	2018 £'000	2017 £'000
Operating profit			
- continuing operations		25,066	20,097
- discontinued operations	5	589	41,137
Adjustments for:			
Depreciation and amortisation	10/11	9,327	25,183
Share-based payments charge		732	739
Profit on disposal of assets classified as held for sale	4	(268)	-
Loss on disposal of property plant and equipment	3	67	1,085
Loss on impairment of goodwill and other intangible assets	3	9,302	-
Loss on impairment of property, plant and equipment	11	87	945
Loss on disposal of investment property	3	1,146	-
Impairment of investment		-	10
Profit on disposal of subsidiary	5	(589)	(38,664)
Cash flows from operating activities		45,459	50,532
Decrease/(increase) in inventories		17,255	(21,223)
Decrease in trade and other receivables		12,383	450
(Decrease)/increase in trade and other payables		(33,699)	33,703
(Decrease)/increase in provisions		(4,904)	6,138
Total cash flows generated by operations		36,494	69,600

Source: Company report

Cash conversion remained good, but I have highlighted the big swing in cash flows from trade payables where last year's big inflow was completely reversed. This shows that these flows can be temporary and need to be taken into account when looking at the sustainability or otherwise of a company's operating and free cash flows.

Marshall's finances are in very good shape with minimal debts. Given the robust cash flows of the business, it has decided to significantly increase its dividend payout ratio. The annual dividend increased by 33.4 per cent, yet still remains just over twice covered by profits.

Marshall Motor Holdings PLC (MMH)						
FORECASTS						
£ millions unless stated						
Year	2018		2019		2020	
Turnover	2,209.0	-1.0%	2,246.9	+1.7%	2,248.6	+0.1%
EBITDA	41.8	+4.8%	40.1	-4.1%	40.4	+0.7%
EBIT	33.3	+126.4%	31.0	-7.1%	31.3	+1.1%
Pre-tax profit	25.6	+103.8%	23.4	-8.8%	23.4	+0.4%
Post-tax profit	20.6	+115.9%	19.4	-5.8%	20.3	+4.9%
EPS (p)	25.8	-55.3%	23.6	-8.5%	23.5	-0.4%
Dividend (p)	6.7	+4.7%	6.8	+1.5%	6.9	+1.5%
CAPEX	26.3	-54.3%	15.8	-39.9%	15.5	-1.9%
Free cash flow	10.4		14.3	+37.5%	16.3	+14.0%
Net borrowing	3.3	+48.7%	-0.6		-8.3	

Source: SharePad

It's difficult to see car dealerships as offering meaningful growth – except perhaps by acquisition – over the next few years but their shares are not priced in expectation of any. At 160p, the shares trade on a forward PE of just 6.8 times and a trailing dividend yield of 5.3 per cent. These are not high quality businesses by any means, but the dividend income looks safe for now and looks quite attractive.



Stobart Group

Back in October last year, I expressed a pretty downbeat view on **Stobart Group (STOB)**. The only thing of value I would like to own a slice of is its London Southend airport where easyJet and Ryanair look well placed to deliver significant levels of passenger growth.

The rest of the business looks messy, while its accounting and cash flows require a lot of scrutiny. Its dividend has not been backed by cash flows and has been reliant on asset sales.

Therefore, it is not really a surprise that the dividend has been slashed to 6p per share as announced in this week's trading update. This has removed the yield support for the shares.

I continue to believe that value uplifts from the expected growth at London Southend airport and the stake in Eddie Stobart Logistics are priced into the shares.

Stobart Group Ltd (STOB)

FORECASTS					
£ millions unless stated					
Year	2019		2020		2021
Turnover	273.7	+13.1%	333.9	+22.0%	373.2 +11.8%
EBITDA	25.1	-81.4%	35.0	+39.2%	48.7 +39.2%
EBIT	11.8		17.5	+48.8%	29.6 +68.8%
Pre-tax profit	8.6		18.0	+108.1%	27.9 +55.3%
Post-tax profit	8.6	-92.4%	16.5	+91.2%	24.2 +46.2%
EPS (p)	2.5	-92.1%	4.7	+88.0%	6.8 +44.7%
Dividend (p)	16.0	-11.1%	10.0	-37.5%	10.0 0.0%
CAPEX	28.8	-61.6%	28.4	-1.4%	18.6 -34.3%
Free cash flow	-40.8		4.2		52.6 +1157.5%
Net borrowing	94.2	+157.3%	95.0	+0.8%	90.4 -4.8%
NAV	361.0	-11.1%	312.0	-13.6%	279.0 -10.6%

Source: SharePad

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