



## Phil Oakley's Weekly Round-Up

*I've been re-acquainting myself with the writings of Benjamin Graham, the father of value investing. This week I look at a mix of companies to assess whether they offer quality value*

### FTSE All-Share price



The companies mentioned this week are:

- Revolution Bars
- City Pubs Group
- Boohoo.com
- Games Workshop
- Somero Enterprises
- JD Sports

After quitting Twitter last autumn – as I felt it was becoming a platform for whingers and negativity – I have recently returned and re-engaged. If you want to follow me, my Twitter handle is [@philJoakley](https://twitter.com/philJoakley).

My view is that Twitter can be a very useful platform for private investors if you are smart with it. When it comes to following people, less is definitely more and, as with many things in life, quality trumps quantity every time. There are some very smart private investors and commentators out there who help you to learn and keep abreast of what's going on in the world of investing. There are also lots of shameless share price rampers talking their own book – you will learn little from them.

One of the most common themes on my Twitter feed at the moment is the amount of cash investors are holding and the related issue of market timing.

Trying to time the market is a futile exercise, but holding cash can protect your portfolio from market falls and put you in a position where you can pick up bargains. However, some investors seem to be holding very large cash balances (some 100 per cent) due to their fear of a stock market crash.

The fear of a crash is a legitimate concern, but obsessing about it is not good for you, as you might miss out on

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some gains. I've always found the best advice is to spread your money around and not have all your money invested in shares.

I am currently re-reading *The Intelligent Investor* by Benjamin Graham, which remains one of the best books the private investor can read. His advice on portfolio allocation for defensive investors (those who want to preserve most of what they have got) is very simple and powerful. In most instances, he says that you should split your portfolio evenly between shares and bonds. Never have less than 25 per cent in shares, but have more than 50 per cent when they are on sale (such as after a crash).

This advice won't suit everyone, but for those of you who want to sleep better and worry less about markets, you might want to read a bit more of Graham's excellent book.

### Revolution Bars

A couple of years ago the bull case for buying shares of premium bar operator **Revolution Bars (RBG)** was that it was a roll-out story that would benefit from cheap rents. This would allow it to earn very high returns on incremental capital employed and allow it to generate rapid sales and profits growth.

This has not come to pass.

Instead, the company has announced a series of profit warnings and has failed to grow its profits at all, despite opening plenty of new bars. Rival operator Stonegate seemed to be prepared to pay 200p per share to take the company over in late 2017, but eventually decided not to. It seems that it has had a lucky escape.

Revolution Bars' presentation of its profits should also be taken with a large pinch of salt in my opinion. It has an obsession with Ebitda (earnings before interest, tax, depreciation and amortization), which is not a proper measure of profit and certainly not for a business that requires regular replacement of fixtures and fittings in order to stay competitive.

It also thinks that investors should ignore costs of share-based payments and the pre-opening costs of bars. These are real costs that transfer value away from shareholders. The fact they are excluded from underlying profits just seems to indicate the lengths management is prepared to go to make their declining profits look as favourable as possible.

It sounds harsh but I think Revolution Bars' business model is badly broken. Trying to sell expensive cocktails – particularly in less affluent provincial towns and cities – does not have a broad enough appeal to be successful and the numbers prove it. The bars are likely to become even less attractive when the economy next goes into a

downturn and consumers tighten their belts.

The company also seems to have a significant cost problem as well – making cocktails can be very labour-intensive – and cannot sell enough food and drink to create much daylight over its fixed overheads and grow its profits.

Despite a decent Christmas and New Year trading performance – where like-for-like (LFL) sales increased by 8.1 per cent – the business has continued to see an overall trend of declining sales and profits. LFL sales for the 26 weeks to the 29 December fell by 4 per cent. After a 5 per cent fall in the first quarter, second-quarter sales fell by 3.1 per cent. With the pub industry's cost inflation running at around 3-4 per cent currently, this is a recipe for falling bar profits.

Half-year profits will be lower with the company taking a very cautious outlook on full-year profits. It currently expects full-year Ebitda of £12m, compared with a consensus of £16.1m and £15m last year – presumably before share-based payments have been taken off – a downgrade of £4.1m

Revolution Bars Group PLC (RBG)						
FORECASTS						
£ millions unless stated						
Year	2019		2020		2021	
Turnover	158.9	+12.0%	170.5	+7.3%	180.9	+6.1%
EBITDA	16.1	+7.5%	17.2	+6.8%	18.6	+7.7%
EBIT	8.1	-0.0%	8.8	+9.1%	8.9	+1.1%
Pre-tax profit	8.1	+7.2%	8.7	+8.3%	9.1	+3.8%
Post-tax profit	7.1	+9.1%	7.8	+9.9%	-	-
EPS (p)	13.6	+4.6%	14.4	+5.9%	15.4	+6.9%
Dividend (p)	5.3	+7.1%	5.6	+5.7%	5.5	-1.8%
CAPEX	13.0	-8.9%	13.0	0.0%	-	-
Free cash flow	10.0	-	10.9	+9.0%	12.1	+11.0%
Net borrowing	12.1	-	12.3	+1.7%	10.0	-18.4%

Source: SharePad

According to my rough and ready forecasts, this would lead to operating profits of £4m, pre-tax profits of £3m, post-tax profits of £2.6m and EPS of 5.2p, and probably a lower dividend. At 93p, this would put the shares on a forecast PE of 17.9 times, which looks to be very expensive unless you believe that profits can recover rapidly.

The company's 79 bars are all rented and its rental commitments will have to go on its balance sheet from this year onwards. Given a rent bill of at least £12m and applying a multiplier of seven times gives an estimated lease debt of £84m. Assuming that the £4m reduction in Ebitda adds to other debt, total debt will be around £100m in June 2019, which would give a lease-adjusted net debt to Ebitda of 4.2 times and the fixed charge cover would be around 1.3 times – Revolution Bars looks very indebted.

Given a weak business model, falling profits, rising debts and an expensive valuation, it is a brave investor



who will be buying the company's shares at the moment. I must admit to being very surprised that a highly respected fund manager added to his already sizeable stake in the company following this week's profit warning. RBG cannot be seen to be anywhere close to being the kind of quality business that Warren Buffett – whose investing style Mr Ashworth Lord's Buffettology fund seeks to copy – would buy in my opinion.

### City Pubs Group

**City Pubs Group (CPC)** listed on the stock exchange just over a year ago and has been doing reasonably well. It has a decent strategy and unlike RBG above, has a business with a decent amount of freehold property backing.

The main focus of its pubs is on selling drinks rather than food, as this has better sales predictability and higher profit margins. This is because food has much higher labour costs (kitchen and serving staff) that drag down margins.

The typical sales split of the pubs is 70 per cent drinks and 30 per cent food. There is a big focus on premium drinks such as craft ales, craft spirits and upmarket coffee. These products offer higher margins than mass market-branded drinks. The food offer is also focused on high quality menus with some emphasis on locally sourced products.

Pub managers are given a lot of freedom in running their pubs and are encouraged to be entrepreneurial. They also get a share of the profits. Around 2-3 per cent of the company's Ebitda is paid out to all qualifying staff in the pubs if the company meets its profit targets.

City Pubs is focusing on growing its estate of premium, unbranded pubs in the affluent parts of the south of England. Each pub is given its own identity tailored to the needs of the local market.

By avoiding brands it can operate a differentiated offer to various types of customers such as local residents, workers, shoppers, students and tourists. This lowers the risk of cannibalising sales when growing the estate.

It also avoids very large pubs as these require significant amounts of refurbishment and maintenance expenditure in order to stay competitive. It also avoids very popular locations such as retail parks, high streets and shopping centres which typically have high rents and high running costs.

Management has a very ambitious plan to double the size of its pub estate over the next few years by buying eight to 10 pubs per year. It will look to buy them from the following sources:

- Existing pubs from private sellers – These are already trading well and usually don't require a lot of extra work. Existing employees are retained and the pub's food and drinks supplies are transferred in order to boost profit margins.
- Pubs that need a bit of money spending on them – Usually around £250,000
- Pubs that need a lot of money spending on them – such as those that have closed.
- Unlicensed premises – getting permission to turn former shops into pubs.

The company uses property agents to find new pubs and also looks at pubs being sold off by the big managed pub companies who are getting rid of underperforming pubs.

Once the pubs have been bought, the directors hope that by keeping interior layouts simple and with regular maintenance they will not need to have to be shut from time to time for big refurbishments. This means they stand a better chance of generating decent amounts of cash flow.

#### City Pub Group PLC (The) (CPC)

#### FORECASTS

£ millions unless stated

Year	2018		2019		2020	
Turnover	46.3	+23.8%	54.5	+17.7%	57.7	+5.9%
EBITDA	7.9	+28.5%	9.8	+24.4%	10.5	+6.4%
EBIT	5.4	+1026.3%	7.1	+30.4%	7.6	+7.7%
Pre-tax profit	5.2		6.8	+31.5%	7.3	+8.3%
Post-tax profit	4.1		5.4	+31.9%	5.7	+5.7%
EPS (p)	7.4		9.4	+27.0%	10.1	+7.4%
Dividend (p)	2.2	-2.2%	2.8	+27.3%	3.0	+7.1%
CAPEX	5.0	-73.8%	8.0	+60.0%	3.0	-62.5%
Free cash flow	3.6		3.8	+4.5%	5.2	+37.2%
Net borrowing	7.8		13.3	+69.7%	9.7	-27.2%

Source: SharePad

The year 2018 has been a satisfactory one for business. Total sales were up by 22 per cent, mainly due to the contribution from new pubs, with LFL sales increasing by 1.6 per cent. Christmas trading across its estate was very good with LFL sales for the six weeks to 6 January up by 7 per cent. As a result, profits for 2018 are expected to be in line with expectations. This makes me think profits would have missed expectations had trading at the end of 2018 not been so strong.

Borrowing will be slightly higher than expected, at just over £10m, due to pub openings with three to four sites expected to be opened in 2019. This should not put any strain on the company's balance sheet given its low level of gearing.

City Pubs should be able to continue its roll-out of new pubs over the next few years and hopes to underpin its LFL sales with recent price increases (it did not increase



prices in 2018). This, in turn, should help it increase profits. That said, at 204p, the shares trade on 21.7 times 2019 forecast EPS which looks pretty fully priced.

### Boohoo.com

**Boohoo (BOO)**, the company that specialises in selling fashionable clothes to young people is a very good business in my opinion. It has consistently been able to deliver impressive rates of sales growth and make a success of companies that it has bought.

The shares defied gravity between the start of 2016 and the middle of 2017, when they were valued at over 100 times earnings. The shares have since lost momentum and de-rated markedly, as the company has not been able to perform significantly better than analysts' expectations on profits.

Boohoo has outperformed on sales but profit margins – on an Ebitda basis – have been coming down and this has largely been responsible for the lacklustre share price performance over the past 18 months.

This week's trading update has provided more of the same – good sales but margin guidance coming down. Sales for the four months to the end of December were up by 44 per cent and by 47 per cent for 10 months. They are expected to be up by 43-45 per cent for the year to February 2019.

The boohoo brand's sales growth has moderated, but is still up by a respectable 15 per cent year to date. Pretty Little Thing and Nasty Gal are growing their sales at impressive rates.

Ebitda margin guidance for the year to February has

Brand	Sales (£m)	Sales growth 10 months to Dec 2018
boohoo	372.5	+15%
Pretty Little Thing	312.8	+114%
Nasty Gal	38.3	+89%

Source: Company report

been moderated to a range of 9.25-9.75 per cent from 9-10 per cent previously. As a result, profits are expected to be in line with current expectations and not above. The shares fell on this news.



#### Boohoo Group PLC (BOO)

##### FORECASTS

£ millions unless stated

Year	2019	2020	2021			
Turnover	836.7	+44.3%	1,089.5	+30.2%	1,376.2	+26.3%
EBITDA	80.2	+40.8%	103.3	+28.8%	130.0	+25.9%
EBIT	65.4	+29.8%	83.4	+27.5%	102.3	+22.7%
Pre-tax profit	66.6	+53.7%	84.2	+26.5%	103.7	+23.1%
Post-tax profit	48.6	+29.3%	60.9	+25.2%	73.5	+20.6%
EPS (p)	4.1	+28.1%	5.1	+24.4%	6.3	+23.5%
Dividend (p)	-	-	-	-	-	-
CAPEX	57.6	+24.2%	87.5	+51.8%	98.0	+12.1%
Free cash flow	8.9	-61.3%	42.0	+370.2%	42.9	+2.1%
Net borrowing	-140.5	-	-146.9	-	-165.8	-

Source: SharePad

That said, Boohoo shares now trade on 33 times rolling forecast EPS when its cash balances are stripped out (net cash balances inflate PE ratios). That is still high, but by no means excessive if it can keep on growing its earnings in excess of 20 per cent for the next few years.

#### Games Workshop

**Games Workshop (GAW)** makes and sells fantasy miniature characters that are sold to collectors for painting and to hobbyists and gamers. It is based in Nottingham and sells its products all over the world via its own network of stores, mail order and third party retailers. About 76 per cent of its sales were outside the UK in 2017-18

This is very much a niche business and is based on human interaction with its products and has very little to do with computers.

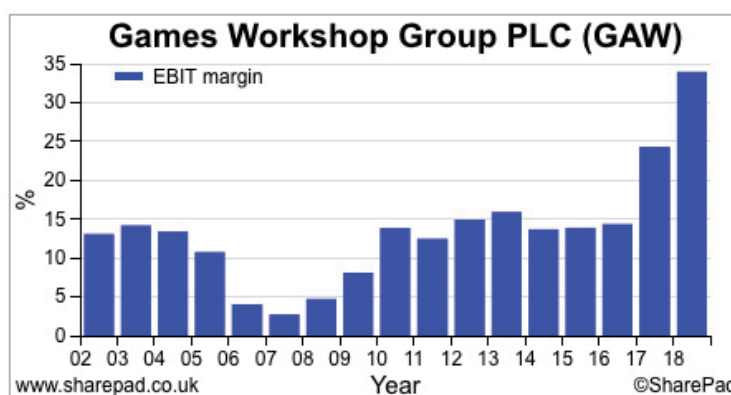
The company has stuck to what it does best over the years and has maintained a profitable niche with its high-quality figures. It has largely avoided the temptation to get sucked into the historical wargame figure market where there is a lot more competition.

Games Workshop is the world leader in fantasy miniature characters and is underpinned by the *Warhammer* and *Warhammer 40,000* brands. It also has the licences for *The Lord of the Rings* and the *Hobbit* tabletop battle games. It has a bank of intellectual property which allows it to develop a continuous stream of new products. When combined with its tooling and manufacturing, there is a significant barrier to entry in this business and a significant benefit from its vertical integration.

The most important part of the business is its network of shops. Many of these are run by one person. The shops are where the company's brand and the promotion of its products are at its strongest as it does not advertise. They are where people can come and see only the newest products and get involved with the many games on offer. They can also order from the entire catalogue of products using web terminals in store.

The company also seems to do a good job of promoting its products elsewhere with its *White Dwarf* magazine, Warhammer TV and the website *warhammer-community.com*, as well as the company's own website. These are used to bring its characters to life and engage existing and new customers.

This is also a business with a high proportion of fixed overhead in the manufacturing and store network which gives it a lot of operational gearing. If it is producing and selling a lot of products then profits can increase rapidly – as has been happening over the past few years – but the process can also work in reverse. A look at its historic profit margin performance shows how volatile they have been.



Source: SharePad

Since 2016, Games Workshop has seen a healthy increase in sales, which has fed through to big increases in profits due to its operational gearing. Half-year results released this week saw this operational gearing muted somewhat as another healthy sales increase did not feed through into much of a profit increase as operating costs rose. Growth in operating profits was essentially due to the increase in royalty income. All that said, its *Warhammer* products continue to be very popular and the recent strength in sales show no signs of wearing off.

## Games Workshop Income Statement

	Notes	Six months to 2 December 2018 GBP000	Restated* Six months to 26 November 2017 GBP000	Restated* 53 weeks to 3 June 2018 GBP000
Revenue	3	125,225	109,572	221,304
Cost of sales		(41,392)	(30,590)	(64,219)
Gross profit		83,833	78,982	157,085
Operating expenses	3	(48,552)	(44,425)	(92,383)
Other operating income – royalties receivable		5,490	3,562	9,617
Operating profit	3	40,771	38,119	74,319
Finance income		38	51	90
Finance costs		–	(50)	(139)
Profit before taxation	5	40,809	38,120	74,270
Income tax expense	6	(7,999)	(7,247)	(14,815)
Profit attributable to owners of the parent		32,810	30,873	59,455
Basic earnings per ordinary share	7	100.8p	96.0p	184.3p
Diluted earnings per ordinary share	7	100.2p	95.2p	181.6p

Source: Company report

The business tends to generate reasonable amounts of free cash flow and continues to earn exceptional returns on capital employed (75 per cent on a trailing twelve month basis). Free cash flow of £17m was £10m lower than the first half of last year due to higher working capital, tax payments and capex. The company's finances remain in rude health with £25.3m of cash on the balance sheet and no borrowings. Surplus cash continues to be paid out to shareholders with regular dividend payments throughout the year.

### Games Workshop Group PLC (GAW)

#### FORECASTS

£ millions unless stated

Year	2019		2020		2021	
Turnover	234.9	+6.8%	246.2	+4.8%	258.2	+4.9%
EBITDA	76.5	-11.9%	80.0	+4.6%	83.0	+3.8%
EBIT	-		-		-	
Pre-tax profit	68.0	-8.8%	71.0	+4.4%	74.0	+4.2%
Post-tax profit	-		-		-	
EPS (p)	168.5	-8.9%	176.0	+4.5%	183.3	+4.1%
Dividend (p)	120.0	-0.0%	130.0	+8.3%	130.0	0.0%

Source: SharePad



Forecasting Games Workshop's profits is not easy as historically it has always been a little bit difficult to know how long the popularity of its products will last. If current profits hold up, the current profit forecasts look to be too low. The TTM EPS is 186.6p, which is already more than the annual forecast for 2021.

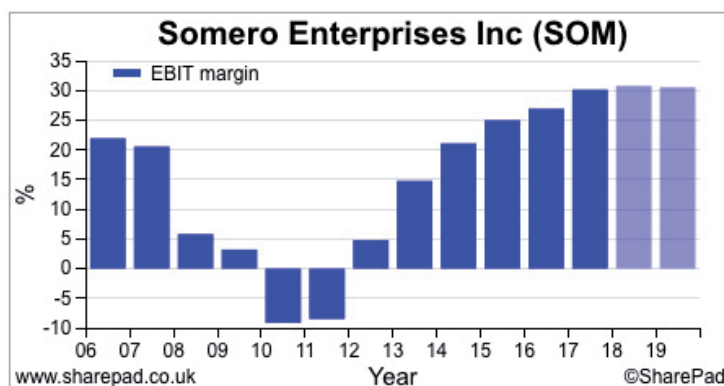
The shares have lost some momentum in recent months since peaking at over £40 last September. A rise during the run up to this week's results statement has not been sustained. At £31.50, the shares trade on a TTM PE of 16.9 times. That's not excessive by any means, but I'm not sure that it's the foundation for a substantial rerating of the shares at the moment.

The company is well managed and is doing well. Over the past few years a lot has been done to suggest that there is a more sustainable and profitable business than may have been the case in the past. As long as this trend continues and profits continue to grow, there's no reason why the shares can't continue to reward patient, long-term shareholders from here.

### Somero Enterprises

**Somero Enterprises (SOM)** is a manufacturer of concrete levelling equipment. Its screeding machines allow its users to install horizontal concrete floors faster, flatter and needing fewer people. It is therefore attractive to building companies looking to do a better job in a more efficient way.

Building is a cyclical business and this has meant that historically demand for Somero's products have tended to be cyclical too. If we look at its profit margins, you can see that Somero has made losses in the past and that profitability – as measured by its profit margins – has now passed the previous cyclical peak. If analysts' forecasts are to be believed, profit margins seem to have peaked.



Source: SharePad

The company is performing very well as its core US business continues to benefit from a healthy construction market, with good trading conditions also in the Middle East.

This week's full-year trading update confirmed that Somero has had a very good 2018 with sales, Ebitda and cash balances ahead of expectations, and sales expected to beat the company's five-year revenue target set in 2014. A decline in sales in China and Europe is a notable disappointment. Latin American sales also fell but saw some improvement during the second half of the year.

The year 2019 seems to be shaping up well with a strong order book in the US and good prospects in Australia and the Middle East. Trading in Europe and Latin America is also expected to improve. One of the most encouraging things about Somero is that it is not just growing due to the strength of its end markets. The launch of new products is also driving growth. The company has high hopes for its *SkyScreed(c) 25* screeding machine, which will be launched later this month and is targeted at the high rise building market.

The company will continue to pay out half of its net profits along with half of its surplus cash over \$15m, which will underpin the current chunky 5.6 per cent forecast dividend yield.

#### Somero Enterprises Inc (SOM)

FORECASTS		\$ millions unless stated			
Year	2018		2019		
Turnover	90.0	+5.1%	94.0	+4.4%	
EBITDA	29.0	+3.6%	30.1	+3.8%	
EBIT	27.7	+7.3%	28.7	+3.6%	
Pre-tax profit	27.7	+7.6%	28.7	+3.6%	
Post-tax profit	21.4	+22.3%	22.7	+6.1%	
EPS (£)	37.7	+21.6%	40.0	+6.1%	
Dividend (£)	24.0	+54.8%	27.0	+12.5%	
CAPEX	2.2	+12.3%	2.0	-9.1%	
Free cash flow	17.4	-2.6%	21.0	+20.7%	
Net borrowing	-24.1		-31.3		

Source: SharePad

Somero has many of the financial hallmarks of an outstanding business. It is growing, has high profit margins and returns on capital and a net cash balance sheet position. Its shares at 333p look very cheap on a one-year rolling forecast PE of just 10 times and a big dividend yield.

The stock market does not give away many free lunches and I don't think Somero is an example of one. The company is in a sweet spot currently, but history tells us that trading and its profits will eventually turn down. The recent share price weakness shows that there is some investor concern as to how long the good times might last.

But are Somero shares a value trap, where a cheap valuation and strong trading performance might entice unwary investors? I think they might be. The company's trading



performance and current rates of profitability suggest that it is nearer the top of a cycle than the bottom. Predicting when the cycle will turn is anyone's guess. I view the shares as quite risky and investors should probably think very carefully before buying.

## JD Sports

**JD Sports (JD.)** is arguably one of the best high street retailers out there. Over the past few years, it has been able to deliver stellar levels of sales and profit growth in the UK while expanding its overseas businesses. Its shares have rewarded long-term holders, but have been stuck in a trading range for the past 18 months or so.

The year 2018 has been another good year with total sales growth of 15 per cent and LFL sales up 5 per cent. Gross margins have been maintained in doing this, so profits are now expected to be at the upper end of market expectations, which implies pre-tax profits coming out at around the £250m mark. In my view, the investment case for JD Sports' shares from here depends increasingly on how well it does outside the UK, particularly in the US.

The company's US strategy would worry me if I was a shareholder. Last March it paid £400m for Finish Line, one of the largest sellers of sports shoes in the US. Selling trainers in the US is a horrible market and very different to the UK.

Price competition is intense. Amazon is a major player in the market and there is an increasing trend followed by major shoe companies to sell directly to their customers and cut out the middleman – the retailer. The tough market was highlighted in Finish Line's wafer thin profit margins of 3 per cent at the time of acquisition by JD.

### JD Sports Fashion PLC (JD.)

#### FORECASTS

£ millions unless stated

Year	2019		2020		2021	
Turnover	4,506.1	+42.5%	5,363.4	+19.0%	5,838.9	+8.9%
EBITDA	457.4	+18.7%	510.7	+11.6%	572.9	+12.2%
EBIT	346.1	+16.3%	388.2	+12.2%	433.5	+11.7%
Pre-tax profit	343.6	+16.2%	385.4	+12.2%	429.1	+11.3%
Post-tax profit	267.4	+9.2%	298.7	+11.7%	334.0	+11.8%
EPS (p)	27.4	+8.7%	30.7	+12.0%	34.1	+11.1%
Dividend (p)	1.8	+10.4%	1.9	+5.6%	2.1	+10.5%
CAPEX	177.9	+2.4%	201.7	+13.3%	218.8	+8.5%
Free cash flow	165.6	+5.6%	205.7	+24.3%	241.6	+17.4%
Net borrowing	-39.0		-220.5		-396.0	

Source: SharePad

It's too early to judge this acquisition, but JD Sports appears to be cautiously optimistic and continues to convert Finish Line stores to the JD fascia. Until investors get a clearer picture of what's going on, it would not surprise me if JD Sports shares continue to trade within their current range.

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