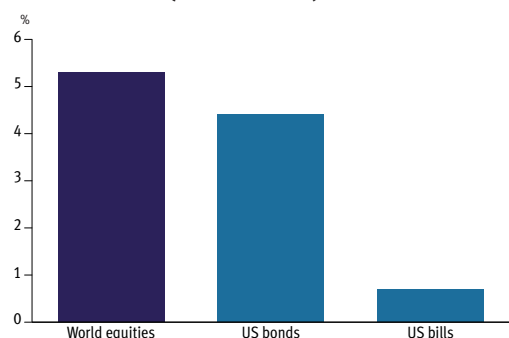




Phil Oakley's Weekly Round-Up

It is hard to get an investing edge to help you beat the market consistently. Learning how to interpret financial statements is one place to start

Being patient: Global real asset returns (1968-2017)



Source: Dimson, Marsh and Staunton, *Triumph of the Optimists*, Princeton University Press, 2002, and subsequent research

The companies mentioned this week are:

- InterContinental Hotels
- McColl's
- Sainsbury's
- Lloyds Banking Group

What is your investing edge?

When you are investing in individual shares with the aim of beating the stock market, you are trying to do something that lots of people are trying to do and is very difficult to achieve consistently. It is a mathematical certainty that all investors cannot beat the market because together they are the market.

So if you are trying to beat the market you have to ask yourself what knowledge or skill set do you have that others don't?

Is it possible to get an information edge?

I think with very small companies it is, as many professional investors ignore them. It gets harder with big, well-researched companies. Having said this, based on my experience of working in the City, if you take the time to read a company's annual report – which most professionals do not do – you can learn some useful things that can help you. This may not help you make money, but it can help identify risks that can keep you out of trouble and help your investment performance.

I ask myself, do I have an edge? Being very honest, I do not think I do. My approach to individual stock-picking is to filter out the many bad companies and concentrate on good ones. I then try not to pay silly prices for them and hope for the best.

The one edge it is possible to acquire is patience. Invest-

Alpha Production Editor: Sameera Hai Baig

ing tends to get very emotional and in the short term boils down to the extremes of fear and greed. The real test of an investor is how they cope with the sight of their portfolio falling in value when the stock market is tanking. I find that many people are long-term buy and hold investors when the outlook is sunny, but tend to panic and run for cash in times of turbulence and are frightened to get back into the market again.

Patience is certainly a virtue when it comes to investing.

Weekly portfolio update

First of all, I must apologise for the error in last week's portfolio performance statistics. I had forgotten to adjust the holding of Intercontinental Hotels for a share consolidation that occurred in January. This overstated the year-to-date returns by 20 basis points and has now been corrected.

The portfolio is currently invested in UK and US shares. Thirty five per cent of the portfolio is invested in US shares and accounted for by seven holdings.

The performance of the portfolio holdings so far in 2019 is ranked in the table below.

Phil Oakley's Fantasy Sipp Portfolio as of 20/2/19

Name	Market cap	Price	% change 31/12/18	% change 1-mth	% change 1-yr
Moody's Corp	\$32264.7	16795	20.4	5.77	0.309
Paychex Inc	\$26861.8	7513	14.8	7.02	14.4
British American Tobacco	£65,383.90	2850.5	14	12.2	-36.6
London Stock Exchange Group	£15,695.50	4508	11	1.21	12.6
Sage Group (The)	£7,194.10	662.6	10.2	4.74	-5.72
Halma	£5,698.50	1501	10	6.23	23.2
3M Co	\$119559.1	20839	9.01	5.71	-11.7
Visa Inc	\$325711.2	14444	8.97	3.84	17.9
James Halstead	£1,042.20	465	8.9	2.2	9.15
Croda International	£6,692.70	5084	8.52	4.12	13.8
Spirax-Sarco Engineering	£4,983.50	6770	8.49	5.7	21.1
Intertek Group	£8,386.00	5196	8.25	2.49	4.48
FTSE All-Share – Total Return	i0.0	7105.93	8.04	3.7	3.08
Diageo	£72,871.40	3014.5	7.85	9.48	20.9
Pepsico Inc	\$162697.8	11593	4.84	5.23	5.8
Avon Rubber	£406.40	1310	4.8	–	9.17
RELX	£33,086.40	1685	4.24	1.08	12.9
Walt Disney Co (The)	\$169493.8	11352	3.7	2.34	7.33
Unilever	£175,248.30	4236	3.1	4.39	13.1
InterContinental Hotels Group	£8,237.00	4545	1.91	2.93	-5.48
McDonalds Corp	\$139064.7	17920	1.5	-1.45	14.8
Hargreaves Lansdown	£7,989.90	1684.5	-8.9	-8.18	-1.06

Source: SharePad & IC

In terms of overall performance, the portfolio is making reasonable money year-to-date, but is lagging the FTSE All-Share Index slightly and a S&P 500 tracker fund by a little bit more. Over a year, it is comfortably beating both.

Terry Smith's Fundsmith Equity fund has got off to a cracking start in 2019 and remains the best managed fund private investors can buy in my opinion.

Name	% change 31/12/18	% change 1-mth	% change 1-yr
Fundsmith Equity T Acc	10.8	7.3	15.3
Vanguard S&P 500 ETF	8.77	3.13	8.96
FTSE All-Share - Total Return	8.04	3.7	3.08
Lindsell Train Global Equity Fund	7.43	5.19	18.4
Phil Oakley Fantasy Sipp	7.1	3.3	12
Finsbury Growth & Income Trust	6.77	3.88	8.21
Scottish Mortgage Investment Trust	6.52	1.68	7.52
Castlefield CFP SDL UK Buffettology Fund	3.74	1.13	6.55

Source: SharePad & IC



Intercontinental Hotels

Intercontinental Hotels (IHG) is one of the biggest branded hotel operators in the world. It is part of my Fantasy Sipp portfolio for the following reasons:

- Hotels remain a growing market as the growth in international travel continues.
- The company has a coherent strategy to grow in different sections of the hotel market and has the brands and IT systems to exploit it – Holiday Inn in mainstream hotels and a selection of upscale and luxury brands such as Intercontinental, Crowne Plaza, Regent, Kimpton and Voco.
- It is a franchisor of its hotel brands and makes most of its money from royalty fees. This gives it a high quality and visible income stream, while the bulk of the running and investment costs of the hotels are borne by the franchisees. This makes the company less operationally-gearred and less risky than owning hotels outright.
- The franchising model is generating very high profit margins, high returns on capital and lots of free cash flow. This should support a growing dividend payout and possibly more special dividends.
- The continued ability to grow across America, Europe, Asia and China creates an opportunity to compound the existing high returns into an even more valuable business.

Full-year results for 2018 were released this week. I'd say they were reasonably good rather than outstanding. Revenues and profits ticked up nicely and the company maintained its very high profit margins, albeit at a slightly lower level than in 2017.

IHG \$m	2018	2017
Americas	1,051	999
EMEA	569	457
Gr China	143	117
Other	170	157
Total Revenue	1,933	1,730
Total Fee income	1,316	12,22
Americas	662	637
EMEA	202	171
Gr China	69	52
Central overheads	-117	-102
Operating profit	816	758
Op margin	42.21%	43.82%
Fee margin	52.50%	52.40%

Source: Company report

The key measure of how well a hotel company is doing is its revenue per available room (revpar). This is calculated by multiplying its occupancy rate by its room rate. IHG takes its percentage royalty fees based on the revpar of its franchised hotels.

	Occupancy %		Room rate \$		REVPAR \$		Fee margin %	
IHG	2018	2017	2018	2017	2018	2017	2018	2017
Americas	69.6	69.4	120.8	118.9	84.1	82.5	74.2	75
EMEA	74.5	73.9	125.4	123	93.4	90.9	61.6	56.1
Gr China	66.8	64.7	85.4	82.5	57.1	53.4	46.3	44.4
Total	70.5	70	117.9	115.8	83.1	81.1	52.5	52.4

Source: Company report

As we can see, occupancy rates and room rates were higher across all regions. Fee margins – the profits earned on royalty fees improved in most areas except the Americas where they remain exceptionally high. Fee margins in Greater China have been growing strongly in recent years and IHG would like to keep pushing these higher.

The outlook for growth looks good with over 270,000 rooms in the pipeline. If delivered, this would increase the size of IHG's business by a third more than it is currently.

Rooms	2018	2017	Pipeline
Americas	510,129	497,460	120,282
EMEA	211,099	199,076	72,743
Gr China	115,313	101,539	77,923
Total	836,541	798,075	270,948

Source: Company report

Around half the room pipeline is expected to come from Holiday Inn and Holiday Inn Express, but there are also plans for a significant push into the upscale and luxury segments of the markets, where the company thinks it can earn good returns.

Free cash generation increased to \$535m (after all capex) compared with \$356m in 2017. This will fund a 10 per cent increase in the final dividend and has led to a \$321m reduction in net debt.



InterContinental Hotels Group PLC (IHG)

Year	2018		2019		2020	
Turnover	1,877.8	+5.3%	1,964.1	+4.6%	2,073.9	+5.6%
EBITDA	876.2	-2.9%	954.5	+8.9%	1,018.4	+6.7%
EBIT	785.8	+3.0%	853.9	+8.7%	907.8	+6.3%
Pre-tax profit	675.3	+0.2%	758.6	+12.3%	836.7	+10.3%
Post-tax profit	562.3	+19.1%	576.8	+2.6%	631.6	+9.5%
EPS (£)	297.3	+16.1%	314.6	+5.8%	350.8	+11.5%
Dividend (p)	93.3	+18.8%	100.5	+7.7%	113.0	+12.5%
CAPEX	237.2	-13.1%	176.0	-25.8%	250.3	+42.2%
Free cash flow	532.2	+34.0%	581.3	+9.2%	616.5	+6.1%
Net borrowing	1,785.7	-3.5%	2,336.6	+30.8%	1,843.6	-21.1%

Source: SharePad

I am happy to keep this share in the portfolio as it remains an excellent business that looks capable of continued steady growth in the years ahead. On a one-year forecast rolling PE of just over 19 times, at a share price of 4604p, I don't think the shares are very expensive.

McColl's

At the other end of the quality spectrum is convenience store operator and newsagent **McColl's (MCLS)**. This is a company that operates in a fiercely competitive sector where customers have no shortage of places to pick up a loaf of bread, a bottle of wine, a lottery ticket or packet of cigarettes.

Things are so tough for McColl's that it can barely sell enough stuff to cover all its costs.

Last year was a difficult one for the business. Its wholesale supplier, Palmer & Harvey went into administration and left McColl's short of stock for its shops, particularly cigarettes. This undoubtedly led to a loss of profitable sales.

The company still made sales of £1.24bn, but only had £18.3m of trading profits compared with £31m in 2017. The problem for McColl's is that this level of profit now looks like its new base level. Costs in the business are increasing such as wages, rents and energy – looks as if it will stop the company growing its profits at all for the next three years.

If you look at the forecasts in the table on page 6, analysts are expecting turnover to increase by just over £89m between 2018 and 2021, but operating profits (the adjusted figures from the company reports) are only expected to grow by £1.7m. Pre-tax profits are expected to grow by a little bit more, as net borrowings are expected to come down from £98m to £81m and reduce interest expenses.

I think this is a business that it is in big trouble.

I also think the 7 per cent forecast dividend yield is by no means safe and that some kind of fresh equity may be needed to put the company on a more stable financial footing. I say this because there are signs of distress easily picked up in the financial statements.

The chief concern must be the near £36m annual rent bill. When taken in combination with the interest bill, McColl's fixed charge cover is just over 1.2 times which is getting towards levels where lenders and suppliers might start to worry.

Another observation comes from the company's operating cash flow. A very large proportion of it is coming from delaying payments to suppliers for the last two years. This is not usually sustainable and could reverse and cause liquidity problems for McColl's.

Consolidated Statement of Cash Flows for the 52 week Period from 27 November 2017 to 25 November 2018

	Note	2018 GBP 000	2017 GBP 000
Cash flows from operating activities			
Profit for the period		6,851	14,192
Adjustments to cash flows from non-cash items			
Depreciation and amortisation	4	17,054	15,636
Profit on disposal of property plant and equipment		(14,994)	(489)
Finance income		—	(93)
Finance costs		8,017	6,721
Share-based payment transactions		—	436
Income tax expense	5	1,016	4,214
Impairment losses		3,297	746
		21,241	41,363
Increase in inventories		(737)	(20,924)
Increase in trade and other receivables		(1,593)	(3,969)
Increase in trade and other payables		48,082	40,561
Decrease in retirement benefit obligation net of actuarial changes		(906)	(1,633)
Increase in provisions		568	3,089
		66,655	58,487
Income taxes paid		(4,811)	(4,267)
		61,844	54,220

Source: Company report

Sadly, I think life is going to be tough for McColl's and its shareholders for a while yet.

McColl's Retail Group Ltd (MCLS)

Year	2019	2020	2021
Turnover	1,267.6	1,299.9	1,330.2
EBITDA	35.8	36.3	38.3
EBIT	18.1	18.4	20.0
Pre-tax profit	11.2	12.1	13.9
Post-tax profit	8.5	8.9	10.5
EPS (p)	7.9	8.3	9.1
Dividend (p)	4.0	4.3	5.1
CAPEX	15.0	18.0	20.0
Free cash flow	12.0	10.1	8.1
Net borrowing	89.2	84.2	81.4

Source: SharePad



Sainsbury's

Staying with the same sector, **Sainsbury's (SBRY)** has had its plans to merge with Asda provisionally blocked by the Competition and Markets Authority (CMA).

This is a big problem for Sainsbury's as its business model does not work in the UK food retailing market. Its stores are too big for its customer base and it cannot compete on price with the discounters such as Aldi and Lidl. This leads to an unattractive financial performance of low profit margins and low returns on capital employed (ROCE).

Asda has also lost its way, despite being backed by the mighty Walmart. The CMA reckons that these two companies getting together will be bad for shoppers and have implications for product ranges and quality – presumably as fewer items would be stocked in the supermarkets – and could push up petrol prices.

Sainsbury's disagrees and thinks it is being treated unfairly as the CMA allowed Tesco to buy Booker despite both of them having a significant convenience store business. The only way the CMA might allow Sainsbury's to merge with Asda is by a significant chunk of stores – big enough to create a viable 4th force in UK retail – being sold off. This is probably unpalatable as it may significantly reduce the cost saving benefits of the merger.

I think Sainsbury's has been somewhat naive to think that it would be allowed to create a business that would control nearly one third of the market. It has been led to this because it is in a weak competitive position.

Where does it go from here?

My guess, for what it is worth, is not upwards.

Sainsbury (J) PLC (SBRY)

FORECASTS

£ millions unless stated

Year	2019		2020		2021	
Turnover	28,990.9	+1.9%	29,263.8	+0.9%	29,655.4	+1.3%
EBITDA	1,438.0	+15.6%	1,460.1	+1.5%	1,481.9	+1.5%
EBIT	713.8	+39.2%	737.4	+3.3%	756.1	+2.5%
Pre-tax profit	629.9	+55.9%	648.5	+3.0%	672.9	+3.8%
Post-tax profit	476.9	+6.7%	497.6	+4.3%	525.3	+5.6%
EPS (p)	20.5	+7.3%	20.9	+2.0%	22.7	+8.6%
Dividend (p)	10.3	+1.0%	10.7	+3.9%	11.3	+5.6%
CAPEX	649.8	-7.3%	640.9	-1.4%	649.2	+1.3%
Free cash flow	490.3	-30.7%	560.8	+14.4%	565.8	+0.9%
Net borrowing	1,379.1	+170.4%	1,051.3	-23.8%	828.5	-21.2%

Source: SharePad



Lloyds Banking Group

I can't invest directly in bank shares. The reasons are very simple: I don't know what I am buying a slice of – you only find out when loans have gone bad after the event – and I think banks are very unimpressive businesses. Their modest returns on equity can only be achieved by taking on lots of debt.

On the face of things, banking is quite simple. The profits and returns to shareholders of a bank are based on a few key drivers:

- The difference between the interest paid to savers and the interest received from borrowers – the net interest margins.
- Income such as fees from selling other financial products.
- The costs of running the bank
- The amount of debt compared with shareholders' equity

Lloyds (LLOY) has had a fairly reasonable 2018. Net interest income increased by 3 per cent with costs flat, leading to an increase in underlying profit of 6 per cent. The underlying return on tangible equity looks pretty decent at 15.5 per cent.

In my opinion, safe banks finance themselves with customer deposits, but Lloyds is still reliant on some wholesale finance with a loans-to-deposit ratio of 107 per cent. I've never put too much faith in tier one ratios, which give assets a risk weighting. I prefer to keep things simple and just look at what amount of equity is supporting the bank's assets.

Lloyds' assets are 16.6 times the amount of equity it has. Put another way, it is financed like having a house with a 94 per cent mortgage. If you base your measure of gearing on tangible equity then the gearing ratio is 21.1 times. That may be better than in the bad days before the financial crisis, but it is still very high. To put this into perspective. Lloyds' return on assets is a meagre 0.73 per cent – what's good about that?

Despite my downbeat assessment, investors cheered the results, which saw a 5 per cent increase in the dividend payout and a bigger-than-expected share buyback.

The 5.4 per cent forecast yield has some attractions and looks safe as long as the UK economy remains stable, but I think investors can get better results putting their money behind better businesses.

Lloyds Banking Group PLC (LLOY)
FORECASTS

£ millions unless stated

Year	2018	2019	2020	
Turnover	18,765.3	18,701.2	-0.3%	18,746.0 +0.2%
EBITDA	-	-	-	-
EBIT	9,485.3	9,742.3	+2.7%	9,962.1 +2.3%
Pre-tax profit	8,333.3	7,878.7	-5.5%	7,963.2 +1.1%
Post-tax profit	5,674.2	5,279.7	-7.0%	5,376.0 +1.8%
EPS (p)	7.8	7.4	-5.1%	7.6 +2.7%
Dividend (p)	3.3	3.5	+6.1%	3.7 +5.7%
CAPEX	-	-	-	-
Free cash flow	-	-	-	-
Net borrowing	-	-	-	-
NAV	37,963.7	37,809.2	-0.4%	39,107.0 +3.4%

Source: SharePad

	2018 GBPm	2017 GBPm	Change %
Net interest income	12,714	12,320	3
Other income	6,010	6,059	(1)
Vocalink gain on sale	-	146	
Operating lease depreciation	(956)	(1,053)	9
Net income	17,768	17,472	2
Operating costs	(8,165)	(8,184)	-
Remediation	(600)	(865)	31
Total costs	(8,765)	(9,049)	3
Impairment	(937)	(795)	(18)
Underlying profit	8,066	7,628	6
Restructuring	(879)	(621)	(42)
Volatility and other items	(477)	(82)	
Payment protection insurance provision	(750)	(1,650)	55
Statutory profit before tax	5,960	5,275	13
Tax expense	(1,560)	(1,728)	10
Statutory profit after tax	4,400	3,547	24
Earnings per share	5.5p	4.4p	27
Dividends per share – ordinary	3.21p	3.05p	5
Share buyback	2.46p	1.40p	76
Share buyback value	GBP1.75bn	GBP1bn	75
Banking net interest margin	2.93%	2.86%	7bp
Average interest-earning banking assets	GBP436bn	GBP435bn	-
Cost:income ratio	49.3%	51.8%	(2.5)pp
Cost:income ratio excluding remediation	46.0%	46.8%	(0.8)pp
Asset quality ratio	0.21%	0.18%	3bp
Underlying return on tangible equity	15.5%	14.0%	1.5pp
Return on tangible equity	11.7%	8.9%	2.8pp

Company report

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