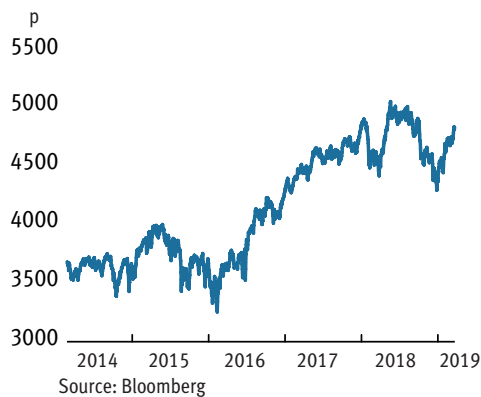




Phil Oakley's Weekly Round-Up

Good companies create value for shareholders, some subjects of this week's round-up have made acquisitions, do the buy cases stack up?

FTSE All Share total returns



The companies mentioned this week are:

- Cineworld
- Judges Scientific
- Restaurant Group
- Ocado
- Asos
- JD Sports

Again, there's not much to report with my Fantasy Sipp portfolio this week, which is ticking along nicely.

Fantasy Sipp vs funds

Portfolio total returns	1 month	Year-to-date	1 year
Fundsmith Equity T Acc	2.1	12.3	16.9
FTSE All-Share – Total Return	2.0	9.7	6.7
Lindsell Train Global Funds	1.8	9.3	21.3
Vanguard S&P 500 ETF	0.4	9.0	9.8
Phil Oakley Fantasy Sipp	1.1	8.8	14.0
Finsbury Growth & Income Trust	1.1	8.5	11.7
Scottish Mortgage Investment Trust	2.1	7.2	10.1
Castlefield CFP SDL UK Buffettology Fund	1.8	5.6	6.5

Source: SharePad

Alpha Production Editor: Sameera Hai Baig



Cineworld

With the continued rise of streaming services such as Netflix, Amazon Prime and Now TV, you could be forgiven for thinking that the days of cinemas are numbered.

That said, if you can't wait three months for the latest blockbuster to become available for download – or DVD – then cinemas are still relevant to you. If last week's results from **Cineworld (CINE)** are anything to go by then cinemas still remain very popular with people.

Last year, Cineworld had 308.4m admissions to its cinemas across the world – 2.6 per cent more than a year ago on a pro-forma basis. Following its big purchase of Regal last year, its fortunes are now largely dependent on the continued health of the US cinema market.

Here, the initial results look reasonable. US admissions were up by 4.9 per cent and sales per admission increased by 3.5 per cent to \$17.07. The UK was weaker with admissions down by 2.6 per cent with the company blaming the hot summer and the World Cup.

But what about the future?

Cineworld is reliant on a steady flow of good films being released that people want to watch. The cost to the consumer of doing so has to remain attractive. The average ticket price at Cineworld is currently running at just over £7, with the company making another £3.22 from people buying food and drink and another £1.28 from adverts and booking fees.

A trip to the cinema for a family of four can quickly add up to a reasonable amount of money, but remains an affordable experience for many. However, my gut feeling is that the way media and entertainment technology are going, the film companies may eventually look to cut out the middleman – the cinemas – and sell direct to consumers via apps.

These can be accessed cheaply on smart TVs and streaming devices and plugged in to a home cinema system. It is the potential for this to happen, and not Netflix and Amazon – who are in a different kind of market – that is the biggest threat to cinemas in my opinion.

We are not at this point yet, but we are getting closer with companies such as Disney – who now own 21st Century Fox – launching a streaming app. In the meantime, companies such as Cineworld are investing heavily in upgrading their cinema screens and sound systems to woo customers. They also offer monthly subscription plans for regular cinema goers.

So how does Cineworld stack up as a business from an investor's point of view?

Not bad, but not great is my view. It's reasonably profit-

able with profit margins of 12 per cent. It also generates a reasonable amount of free cash flow, with free cash flow margins of 8.7 per cent last year.

What spoils things somewhat is the whopping amount of money that it paid for Regal last year. Cineworld paid \$5.8bn (£4.3bn at the time) for a business that had annual operating profits of \$339m – a starting return on investment of just 5.8 per cent.

Taking this into account, Cineworld's return on capital employed (ROCE) in 2018 was just 5.6 per cent. Stripping out the \$5.8bn of goodwill – the excess over net asset value (NAV) paid when buying companies – on its balance sheet there is a half reasonable business with a ROCE on operating capital employed of 15.2 per cent.

Cineworld Group PLC (CINE)

FORECASTS

\$ millions unless stated

Year	2019	2020	2021
Turnover	4,873.0 +18.3%	5,015.2 +2.9%	5,189.2 +3.5%
EBITDA	1,126.8 +37.5%	1,181.1 +4.8%	1,241.6 +5.1%
EBIT	788.6 +58.0%	799.3 +1.4%	836.5 +4.7%
Pre-tax profit	556.7 +57.9%	610.7 +9.7%	640.1 +4.8%
Post-tax profit	456.7 +59.0%	500.2 +9.5%	538.9 +7.7%
EPS (p)	32.9 +21.0%	36.1 +9.7%	38.1 +5.5%
Dividend (p)	13.6 +16.3%	14.9 +9.6%	15.6 +4.7%
CAPEX	309.2 +92.6%	330.5 +6.9%	320.8 -2.9%
Free cash flow	525.2 +46.8%	655.6 +24.8%	678.3 +3.5%
Net borrowing	3,552.6 -4.8%	3,193.8 -10.1%	2,944.9 -7.8%

Source: SharePad

The price paid for Regal has loaded up Cineworld's balance sheet with lots of debt – equivalent to 3.7 times on a net debt to earnings before interest, tax, depreciation and amortisation (Ebitda) basis, which is pretty high and adds extra risk for shareholders. It needs to keep profits and free cash flows growing to get this down to a sensible number. According to current analyst forecasts, net debt to Ebitda will still be 2.4 times in 2021.

It seems that the market also has some concerns over this company. Its shares are quite lowly rated on a one-year rolling forecast PE of 11.9 times, while the yield is chunky at 4.5 per cent at a share price of 300p. That might be tempting for income-seekers, but the business and financial risks with this company are high in my view.

Judges Scientific

If you were to run a stock screener with a set of quality financial performance criteria, with some growth added on top, then you would probably come across **Judges Scientific (JDG)**. Last year it had operating margins of 18.9 per cent, ROCE of 29.7 per cent and a free cash flow margin of 15 per cent.

These are the kind of numbers that would certainly get



me to take a closer look at a company and try and understand how it performs so well.

Judges designs, produces and sells scientific instruments that are used in a large and diverse number of applications. The company talks bullishly about the long-term growth prospects for its products from the growth of science, research and development and higher education.

How a company grows is very important to the investor. The quality of growth matters a lot. The best source of growth is based on selling more from what the company already has – known as organic growth. The other ways are to invest in new projects and buy companies.

Judges aims to grow both organically and by buying other instrument companies. Over the past five years, its operating profits have almost doubled to £14.7m as it has spent over £50m on acquisitions.

I'm always wary when I see companies trying to grow by acquisitions, as they can often overpay in doing so, while masking weak organic growth. This doesn't seem to be happening at Judges where there was organic revenue growth of 5.5 per cent last year. The high ROCE tells us that acquisitions are not destroying value for investors.

Yet, a couple of things about Judges and its acquisitions intrigue me. The first is that the company largely has a fixed cost base. Adding the sales of an acquired business onto this fixed cost base – and taking out duplicate costs – can give big increases in profits. Organic sales growth would have an even more powerful effect. High fixed costs tell an investor that a business is highly operationally geared and that gearing can work in a downwards as well as an upwards direction.

The other thing is that Judges' buying strategy is based on paying very low multiples of profits for businesses. It wants to buy companies with strong profit margins and sustainable cash flows that are capable of exporting into niche markets across the world. In return, it wants to pay between three and six times operating profit, which is a very low multiple for a business with these characteristics.

Judges Scientific PLC (JDG)						
FORECASTS						
£ millions unless stated						
Year	2018		2019		2020	
Turnover	75.3	+5.5%	79.6	+5.7%	81.6	+2.5%
EBITDA	12.4	+9.7%	-	-	-	-
EBIT	-	-	-	-	-	-
Pre-tax profit	10.8	+97.6%	14.8	+37.0%	15.2	+2.7%
Post-tax profit	-	-	-	-	-	-
EPS (p)	153.0	+17.4%	184.7	+20.7%	189.8	+2.8%
Dividend (p)	33.6	+5.0%	44.0	+31.0%	48.4	+10.0%
CAPEX	-	-	-	-	-	-
Free cash flow	-	-	-	-	-	-
Net borrowing	0.2	-97.4%	-10.1	-	-19.9	-

Source: SharePad



The way I see this is that it is either a sign of great management or naive sellers, or perhaps a sign that the true underlying value of these businesses is not very high.

At 2,890p, Judges Scientific is valued at 12.9 times its trailing operating profits or 15.7 times trailing EPS. Steady growth and high returns are a good mix, but I've never been persuaded that investors should pay up for acquisition led growth.

The shares have performed very well and could continue to do so if growing revenues continue to leverage the high fixed costs. Revenues are exposed to public spending risk on higher education, but I'm not sure I really understand the nature and sustainability of this business enough to have a strong view on it.

Restaurant Group

I'll get straight to the point: I don't like **Restaurant Group (RTN)** as a business. It has over-invested in a saturated UK casual restaurant market and has destroyed huge amounts of value for its shareholders.

It is now trying to save itself by buying Wagamama from private equity sellers for a very high price. Private equity sellers are no mugs and are very good at maximising their return on investment by selling out of a business without leaving much on the table for the buyer.

I hear good things about Wagamama from friends who eat there. Its numbers remain very good with like-for-like (LFL) sales in its recent quarter increasing by 9.1 per cent. Restaurant Group needs Wagamama to keep delivering stellar rates of growth to make a decent return on its investment. It might do so, but the risks given the hefty price tag paid remain high.

Frankie & Benny's and Chiquitos look tired Restaurant brands and I struggle to see how these can deliver meaningful growth. They may, however, give opportunities for conversion to Wagamama going forward. I am more upbeat about the company's pubs and airport concessions.

Restaurant Group (The) PLC (RTN)						
FORECASTS						
£ millions unless stated						
Year	2019		2020		2021	
Turnover	1,083.6	+58.0%	1,152.8	+6.4%	1,199.8	+4.1%
EBITDA	150.1	+137.6%	169.2	+12.8%	185.4	+9.6%
EBIT	94.2	+207.0%	111.0	+17.8%	126.6	+14.1%
Pre-tax profit	80.0	+174.4%	97.6	+21.9%	112.3	+15.1%
Post-tax profit	61.4	+219.1%	75.6	+23.1%	86.8	+14.9%
EPS (p)	12.8	-12.3%	15.4	+20.3%	18.0	+16.9%
Dividend (p)	6.4	+28.8%	8.8	+37.5%	8.9	+1.1%
CAPEX	85.6	+74.6%	86.7	+1.3%	80.0	-7.8%
Free cash flow	43.9	+42.1%	57.3	+30.4%	76.7	+33.9%
Net borrowing	310.6	+3.8%	313.4	+0.9%	284.6	-9.2%
NAV	-	-	-	-	-	-
Like for like sales growth %	2.1		2.2	+2.3%	2.8	+28.8%

Source: SharePad



I can see why bargain hunters might want to buy shares in Restaurant Group given the low valuation – less than 10 times forecast rolling EPS – and a yield of over 5 per cent. That said, this is a business with high operational and financial gearing in a horrible sector. If Wagamama delivers then the upside from here could be big, but if it does not it will be very messy.

Ocado

Ocado's (OCDO) first-quarter trading update doesn't really change anything as far as investors are concerned.

While revenues and weekly orders were up by a little over 11 per cent, Ocado still has a long way to go before it can demonstrate that it can make meaningful profits from selling groceries over the internet. In many ways, the pressure is off it a little bit given that it has agreed to sell half of its UK business to Marks & Spencer for up to £750m (valuing the whole business at £1.5bn).

This valuation could be seen as being very generous for a business that currently makes no operating profits. So it all comes back to how can you justify Ocado's current market capitalisation of £8.4bn?

Ocado Group PLC (OCDO)						
FORECASTS			£ millions unless stated			
Year	2019		2020		2021	
Turnover	1,745.0	+9.1%	2,073.9	+18.9%	2,224.5	+7.3%
EBITDA	51.4	-13.6%	126.2	+145.4%	175.7	+39.3%
EBIT	-53.7		13.4		108.8	+709.7%
Pre-tax profit	-63.3		-17.6		-39.0	
Post-tax profit	-60.7		-8.0		-2.9	
EPS (p)	-10.1		-1.6		-0.4	
Dividend (p)	-		-		-	
CAPEX	349.0	+105.2%	299.7	-14.1%	313.5	+4.6%
Free cash flow	-289.2		-185.6		-199.4	
Net borrowing	222.9		282.5	+26.7%	263.1	-6.9%

Source: SharePad

It all comes down to it signing up more grocery retailers to use its warehouse technology and software. Based on the current deals it has already signed off, its annual report shows £1.3bn of future profits are possible. It therefore needs its deal with Kroger in the US to fly and move from three customer fulfilment centres (CFCs) to 20 or more. This is arguably already priced into the shares.

The fire at its Andover CFC will reduce UK sales growth in the short term, but using new capacity at Erith will offset some of the damage. The Andover facility will be rebuilt once the fire damage has been cleaned up.

Ocado shares continue to puzzle me and many others. They are up 53 per cent year-to-date and remain a momentum and sentiment-driven share rather than anything that can be supported by current known fundamentals.



Asos

Arguably, a share that is equally as puzzling is online fashion retailer **Asos (ASC)**. Despite a massive profits warning in December, its shares are up by 35 per cent year-to-date.

Second-quarter results announced this week were satisfactory with the UK holding up well, but tempered by challenging markets in France and Germany. The US has had a few teething troubles fulfilling orders, but these have now been sorted out. Current guidance for 2019 profits was maintained.

£m ¹	Three months to 28 February				Six months to 28 February			
	2019	2018	Reported Increase	CCY ²	2019	2018	Reported Increase	CCY ²
UK retail sales	244.4	214.9	14%	14%	481.5	414.5	16%	16%
EU retail sales	198.4	177.0	12%	8%	402.2	349.1	15%	10%
US retail sales	76.6	73.8	4%	(3%)	161.6	149.0	8%	4%
ROW retail sales	121.9	101.4	20%	21%	236.0	218.7	8%	9%
International retail sales	396.9	352.2	13%	9%	799.8	716.8	12%	9%
Total retail sales	641.3	567.1	13%	11%	1,281.3	1,131.3	13%	11%
Total group revenue³	658.5	581.4	13%	11%	1,314.5	1,158.1	14%	12%

¹All numbers subject to rounding throughout this document, ²Constant currency is calculated to take account of hedged rate movements on hedged sales and spot rate movements on unhedged sales, ³Includes retail sales, delivery receipts and third-party revenues

Source: Company report

My concern for this business is that it is slashing prices to maintain sales growth – gross margins are expected to fall by 150 basis points this year – which is expected to produce operating profit margins of just 2 per cent.

Asos has moved from a business with very low profit margins to one that is now marginally profitable. Consumers may like the convenience of ordering goods over the internet, but it is very difficult to make good money from the companies doing the selling.

ASOS PLC (ASC)

FORECASTS

£ millions unless stated

Year	2019		2020		2021	
Turnover	2,783.5	+15.1%	3,257.5	+17.0%	3,791.8	+16.4%
EBITDA	137.1	-12.5%	185.9	+35.6%	243.8	+31.1%
EBIT	55.9	-45.3%	85.4	+52.7%	117.6	+37.7%
Pre-tax profit	56.0	-45.1%	83.6	+49.2%	115.5	+38.2%
Post-tax profit	44.9	-45.5%	66.9	+48.9%	93.5	+39.7%
EPS (p)	53.0	-45.9%	81.7	+54.2%	112.4	+37.6%
Dividend (p)	-		-		-	
CAPEX	199.5	-6.3%	209.4	+5.0%	209.3	-0.0%
Free cash flow	-72.9		-7.4		63.3	
Net borrowing	42.5		62.1	+46.0%	28.3	-54.4%

Source: SharePad



Clothing has a big operational issue with the logistics of handling lots of returned goods, which is costly. Despite the upfront investment that is needed in IT, warehousing and delivery vans, competition remains high. Asos is a long way from making returns on investment that many people would consider to be satisfactory.

Yet its shares, at 3,093p, trade on a one-year rolling PE of 45 times with negative free cash flows. I am not convinced that the profit margin recovery implied by current analysts' forecasts should be taken for granted. Another high-risk share that trades on sentiment and therefore remains very risky.

JD Sports

I've written before that I think **JD Sports (JD.)** is arguably the most accomplished retailer on Britain's high streets. It has communicated brilliantly with its customer base in trainers and sportswear – so much better than Sports Direct – and has produced excellent results for its shareholders.

Its decision to buy Finish Line in the US does concern me given its wafer-thin profit margins and the fierce competitive market for trainers on the other side of the Atlantic. This week's move to buy loss-making **Footasylum (FOOT)** in the UK looks to be a more canny deal.

This looks like a very simple deal about buying power to me. JD Sports, by using its far superior scale and buying power, can take Footasylum's £225m of sales and make a reasonable profit from them. If it could get this business to make margins of 7 per cent or more (not too unreasonable an assumption given JD's UK business) then it would be making profits of £15m, compared with the implied value of £90m it is paying.

JD Sports Fashion PLC (JD.)						
FORECASTS						
£ millions unless stated						
Year	2019		2020		2021	
Turnover	4,557.7	+44.2%	5,511.3	+20.9%	5,912.3	+7.3%
EBITDA	464.1	+20.5%	518.7	+11.8%	576.5	+11.1%
EBIT	351.9	+18.2%	418.3	+18.9%	465.7	+11.3%
Pre-tax profit	348.4	+17.8%	392.7	+12.7%	431.1	+9.8%
Post-tax profit	270.6	+10.5%	302.4	+11.8%	332.1	+9.8%
EPS (p)	27.7	+9.9%	31.2	+12.6%	34.5	+10.6%
Dividend (p)	1.8	+10.4%	2.0	+11.1%	2.3	+15.0%
CAPEX	174.1	+0.1%	201.6	+15.8%	214.3	+6.3%
Free cash flow	173.6	+10.7%	204.8	+18.0%	240.9	+17.7%
Net borrowing	-72.5		-234.0		-420.0	

Source: SharePad

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