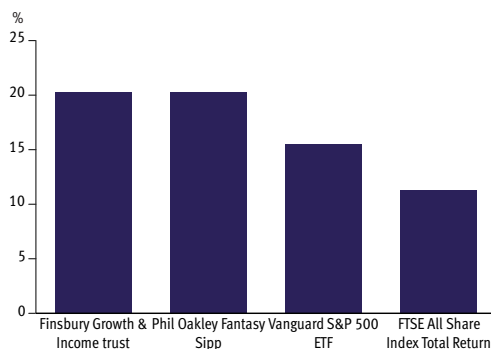




Phil Oakley's Weekly Round-Up

Investors should always ask themselves about the sustainability of companies' business models and, if they're buying a share for income, whether the dividend policy is viable in the long term, too

Fantasy Sipp year-to-date percentage returns compare well



The companies mentioned this week are:

- Marks & Spencer
- SSE
- Britvic
- WH Smith
- Foxtons
- Forterra
- City Pub Group

As usual, the companies in this week's round-up are a mixed bag, although a common theme is assessing how they can continue to operate in the future. Arguably, **Marks & Spencer (MKS)** is in terminal decline. Other companies such as utility firm **SSE (SSE)**, that have always been sold to investors as income stocks, may not be able to maintain generous payouts. There are, however, other companies with strategies that I am more positive about, including soft drinks manufacturer **Britvic (BVIC)** and building materials supplier **Forterra (FORT)**.

Fantasy Sipp performance

	Portfolio returns(%)		
	1 month	Year to date	1 year
Finsbury Growth & Income Trust	4.06	20.3	12.2
Phil Oakley Fantasy Sipp	3.6	20.3	17.3
Fundsmith Equity T	2.92	19.6	18.2
Lindsell Train Global Funds	4.28	19.3	20.9
Castlefield CFP SDL UK Buffettology Fund	4.49	17.1	12.5
Vanguard S&P 500 ETF	1.7	15.5	10.9
FTSE All-Share – Total Return	-1.22	11.3	-3.32
Scottish Mortgage Investment Trust	-2.55	10.3	1.98

Source: SharePad

Alpha Production Editor: Sameera Hai Baig



Marks & Spencer

I struggle to see **Marks & Spencer (MKS)** as anything more than a slowly dying business. It is dying because its food and clothing businesses do not have a broad enough appeal with shoppers. Its online strategy is years behind its competitors.

Its food is overpriced, while its clothing range does not seem to appeal to anyone under the age of 60. This is evidenced with its food like-for-like (LFL) sales being down by 2.3 per cent and clothing down by 3.9 per cent for the year to March 2019. Its UK trading profits fell by 11.5 per cent before large one-off costs were taken into account.

Its shareholders are paying a heavy price for its woes. The company is closing over 100 of its stores – three quarters of them are over 25 years old and in bad locations – and cutting its prices. It is also paying up to £750m for a 50 per cent stake in Ocado, which seems to do little to address its online grocery presence given the average basket size at M&S is so small. The cost is a 25 per cent cut in the annual dividend and a £601m rights issue at a 32 per cent discount to Tuesday night's closing price.

Marks & Spencer forecasts

	2019	Year (£m) 2020	2021
Turnover	10,381.50	10,304.60	10,313.20
Ebitda	1,151.10	1,105.60	1,082.40
Ebit	597.6	575.6	570.6
Pre-tax profit	520.6	505.1	512.5
Post-tax profit	399.3	393.5	396.1
EPS (p)	24.8	23.3	23.1
Dividend (p)	15.4	13.8	13.7
Capex	322.5	360.7	375.6
Free cash flow	501	459.3	460.5
Net borrowing	1,654.70	1,493.20	1,308.50
NAV	3,053.20	3,125.00	3,198.00
Like-for-like sales growth (%)	-2	-0.1	0.3

Source: SharePad

This is sadly a broken business and the strategy to put it on track looks just like applying sticking plasters to a big self-inflicted wound. It is very difficult to see how it can be fixed or get over how deeply entrenched it is with a shrinking customer base – wealthy older people – and how it can lower its prices to appeal to a broader base in crowded and competitive markets.



SSE

I've thought for many years that **SSE (SSE)** had become a slave to a dividend payout that was unsustainable. I thought this as the company had invested billions of pounds in power generation projects and racked up higher and higher debt levels without growing its profits. Something eventually had to give.

The profits in its energy supply business have been decimated by competition and government-imposed price caps. SSE sought a way out of this business by merging it with npower's and cutting its dividend to 80p per share in the process from just over 97p per share this year. The npower deal has been scrapped, but the dividend cut has stayed in place.

What surprises me is that SSE is still dangling a dividend policy of growing the payout from its new base of 80p by at least the rate of RPI inflation until 2023. What happens next is what investors need to focus on.

SSE's key assets, as far as its dividend is concerned, are its electricity transmission and distribution networks and its portfolio and wind farms. Ofgem, the electricity regulator, will review the prices that SSE's transmission and distribution businesses can charge its customers in 2021 and 2023, respectively. The danger is that the regulator will force it to cut prices and lower the allowable rate of return it can earn on its assets. In other words, there is a risk that the current 80p dividend is unsustainable in any case.

SSE forecasts

	2019	Year (£m) 2020	2021
Turnover	29,161.90	31,540.10	32,036.60
Ebitda	1,966.90	2,369.00	2,547.20
Ebit	1,147.00	1,483.50	1,659.50
Pre-tax profit	768.6	1,142.30	1,337.50
Post-tax profit	700.8	967	1,119.70
EPS (p)	67.1	94.4	107.6
Dividend (p)	97.6	80	82.3
Capex	1,638.50	1,277.20	1,115.40
Free cash flow	183	766.3	1,145.50
Net borrowing	9,732.50	9,685.30	9,507.30
NAV	4,788.00	4,841.00	5,347.00

Source: SharePad

There are good grounds for thinking that this is a real threat. SSE is pinning its hopes on adding a further eight gigawatts of mainly offshore wind farms to its business and adding more electricity transmission lines out to the Scottish islands, in order to increase its profits.

The stock market seems to take an equally dim view. At a share price of 1014p, the shares are yielding around 8 per cent, which is the kind of level that often signals a



dividend cut. SSE still looks very risky for income-seekers even without factoring a potential re-nationalisation under a future Labour government.

Britvic

I like soft drinks businesses. They are popular products which tend to be bought regularly by consumers. Strong brands attract loyal consumers and can give rise to stable and steadily growing revenues, profits and free cash flows.

Britvic (BVIC) ticks a lot of boxes in this respect. Its drinks portfolio is underpinned by having the UK and Irish licences to make and sell Pepsi and 7Up. These are complemented by its own strong brands such as Robinsons and Tango.

The company has navigated the UK sugar tax well and its Pepsi Max and 7UP brands seem to be doing well from it. Tango has also had a revival, which should get a further boost from a brand relaunch later this year.

The Robinsons still drinks portfolio is being driven by its Fruit Creations premium brand, which is taking the brand more upmarket with higher prices and better margins. Overseas, in France and Ireland, the company is achieving a better sales and margin mix. Sales in Brazil have bounced back from a weak performance a year ago.

The outlook for the business still looks pretty decent for the long haul, in my view. The company is close to the end of an efficiency drive: an investment project which has put the business on a good platform for the future. Capex spending is going to come down and free cash flow generation is expected to go up, as a result.

Britvic forecasts

	2019	Year (£m) 2020	2021
Turnover	1,564.30	1,600.20	1,634.50
Ebitda	269.7	283.7	293.7
Ebit	208.6	221.4	231.9
Pre-tax profit	189.5	200.5	212.2
Post-tax profit	153.1	162.7	169.5
EPS (p)	58.5	62.2	65
Dividend (p)	29.8	31.4	33
Capex	74.9	67.1	68.2
Free cash flow	119.3	159.9	162.4
Net borrowing	553.5	475.8	414.2

Source: SharePad

The shares have done quite well so far this year and are up by nearly 16 per cent. With the company on track to meet full-year forecasts, the shares still look reasonably valued on a one-year rolling forecast PE of 15.2 times, while offering a dividend yield of 3.2 per cent at a share price of 929p.



WH Smith

WH Smith (SMWH) continues to trade well and I am happy to keep the shares in the Fantasy Sipp portfolio. I see the shares as a growing play on the travel retail sector, which continues to have far superior economics to the UK high street and is the biggest and growing source of WH Smith's profits.

The company's high street stores are actually holding up quite well. During the 11 weeks to 18 May, LFL sales fell by just 1 per cent. With cost savings on track to be delivered, the profits for this business look on course to meet expectations.

The more important travel division continues to perform well, with LFL sales up by 3 per cent. The UK business is on track to open 20 new outlets this year, with 10 in hospitals where trading remains good. The new pharmacy format at Gatwick airport is working well, which augurs well for a future rollout.

WH Smith forecasts

	2019	Year (£m) 2020	2021
Turnover	1,385.10	1,441.10	1,500.00
Ebitda	207.6	221.6	235.6
Ebit	160.4	171.9	183
Pre-tax profit	155.1	167.1	177.6
Post-tax profit	124.8	134.8	143.3
EPS (p)	116.1	126.6	136.7
Dividend (p)	57.8	62.6	68.6
Capex	59.8	56.9	58.1
Free cash flow	106.1	124.5	137
Net borrowing	170	133.4	104.1

Source: SharePad

Overseas continues to grow and it appears that the recently acquired In-Motion business is continuing to perform.

I continue to think that this business is doing what it has been doing for years very well. It is managing the decline of the high street business and looks well prepared to exit problem locations which are on favourable short-term leases. Meanwhile, the business continues to produce lots of free cash flow to be reinvested in the higher returning travel division.

The business continues to offer steady growth over the next few years. Some might point to the announced departure of the chief executive as a bad sign and possibly another leader getting out at the top. This is always possible, of course, but his replacement knows the business well, having run both the company's businesses over the past five years and has spent his entire career in retail. He is taking over a business in good shape.



Foxtons

Foxtons (FOXT) continues to suffer in a very weak London housing market. The days of making 2.5 per cent commission for selling lots of expensive houses seems a long time ago. Sales volumes for the company are at record low levels and unlike Purplebricks, no sale means no income. If it wasn't for its lettings business then the company would be in dire straights now.

That said, the company is not expected to make any money any time soon, but unless the losses get bigger its £15m of net cash balances should stop it from going out of business.

Foxtons forecasts

	2019	Year (£m) 2020	2021
Turnover	106.4	108.1	113
Ebitda	1.5	2.4	-
Ebit	-1	-2	-1
Pre-tax profit	-2.7	-2.7	-1
Post-tax profit	-3	-3	-3
EPS (p)	-0.9	-0.8	-1
Dividend (p)	-	-	-
Capex	1	1	1
Free cash flow	-	-	1
Net borrowing	-18	-18	-19

Source: SharePad

I see little to support the shares at the moment. It's not as if there is any asset backing from freehold office properties. The London property market was arguably a big bubble and one that hasn't popped properly yet, as valuations remain very stretched.

Forecasting profits for a business like this is quite difficult. The rental income should be quite stable (60 per cent of sales), but there is still a lot of damage to profits that can be done if sales revenues fall sharply from last year's £36m. Shareholders are unhappy about management bonuses for last year. Cutting them back could be a source of forecast upside.

You have to be quite brave and very patient to own these shares.

Forterra

While housebuilding and therefore demand for bricks is cyclical, I like brickmakers as businesses. Their reserves of clay are scarce assets, which make competition against owners difficult. Given the positive long-term demand for housing in the UK, low stocks of bricks and demand exceeding supply, owning shares in a brickmaker such as **Forterra (FORT)** looks to be a good place to be right now.

Trading for the first four months of the year has been



reasonable, with sales up by 7.8 per cent. Brick volumes are modestly ahead of last year, but price increases have been secured to offset rising costs. Concrete floor beam sales are seeing good growth, while the precast concrete business is performing a lot better than last year. Profit forecasts are on track to be met at the moment.

The company has received permission to build a new £95m brick factory in Leicestershire, which will be capable of making 180m bricks per year. It will replace an existing facility making 85m bricks. It will be the largest and most efficient brick factory in Europe and will start making bricks in 2022. Providing capacity utilisation is kept high, this augurs well for keeping margins high.

Forterra forecasts

	2019	Year (£m) 2020	2021
Turnover	385.5	398.7	410
Ebitda	84.5	87.3	92.1
Ebit	71.2	73.5	76.6
Pre-tax profit	67.7	70.4	74.1
Post-tax profit	55.4	57.5	59.9
EPS (p)	27.5	28.8	30.2
Dividend (p)	11.5	12	12.6
Capex	41.4	31.9	54.8
Free cash flow	38.1	41.3	18.3
Net borrowing	46.6	37.7	50.4

Source: SharePad

Forterra shares have done well so far this year and are up by nearly a third. However, they still look reasonable value on a one-year rolling forecast PE of 10.6 times, while offering a forecast dividend yield of 3.9 per cent backed by good underlying free cash flow generation.

City Pub Group

When I am looking at retailers and pub companies, I want them to tell me how their existing assets are performing. I want to know the LFL sales performance. It's easy to grow these businesses by opening new outlets or buying them. The test of whether you are looking at a good pub operator is whether it can grow its LFL sales.

One of the things that made me suspicious about Patisserie Holdings was that it never disclosed a LFL sales figure. **City Pub (CPC)** has not done so either in its latest trading update for the first 19 weeks of the year.

I'm not a great fan of pubs as investments, but I do think that City Pub has quite an attractive strategy to build up the value of the business. It currently has 45 pubs open and hopes to have 65 to 70 by 2021.

Its main focus is on selling drinks rather than food, as this has better sales predictability and higher profit mar-



gins. 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. About 2-3 per cent of the company's earnings before interest, tax, depreciation and amortization (Ebitda) is paid out to all qualifying staff in the pubs if the company meets its profits targets.

City Pub is focusing on growing its estate of premium, unbranded pubs in 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.

The company 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.

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 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.

But how well is City Pub really doing? We know that its sales are 35 per cent higher than a year ago, but without telling us what the LFL sales is, it's difficult to tell. Last year it was relatively weak at 1.6 per cent. You can't help thinking that it isn't that good or it would have been mentioned.

For me, JD Wetherspoon is the best pub operator in the country with its recent LFL sales growth of 7.6 per cent. I quite like what City Pub is trying to do, but it needs to demonstrate it has a growing underlying business. With industry cost inflation running at 3-4 per cent presently, my guess is that LFL sales are growing by less. This means underlying profit per pub is probably falling, which

makes me think that the shares on 24 times tolling forecast EPS look quite expensive.

City Pub forecasts

	2019	Year (£m) 2020	2021
Turnover	58.7	64.4	66.2
Ebitda	10.5	12	12.2
Ebit	7	8.1	8.5
Pre-tax profit	6.8	7.7	8
Post-tax profit	6	6	6.5
EPS (p)	8.9	9.8	10.4
Dividend (p)	3.1	3.4	3.6
Capex	8	4	4
Free cash flow	4.3	6.2	6.3
Net borrowing	24.8	21.7	17.4

Source: SharePad

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