



Phil Oakley's Weekly Round-Up

So far this year, having overseas exposure – particularly US shares – has worked for investors, as my Fantasy Sipp performance has shown

The companies mentioned this week are:

- Greene King
- Persimmon

Fantasy Sipp performance

	1 month	Portfolio returns (%)	
		Year to date	1 year
Fundsmith Equity T Acc	0.3	29.6	17.8
LF Blue Whale Growth Fund	-1.7	29.0	16.5
Phil Oakley Fantasy Sipp	0.5	27.0	19.6
Lindsell Train Global Funds	1.4	26.8	19.5
Martin Currie Global Portfolio Trust	-4.9	26.3	12.7
Mid Wynd International Inv Trust	-0.7	25.6	10.9
Smithson Investment Trust	-1.1	23.8	
Finsbury Growth & Income Trust	-1.6	23.2	10.9
Vanguard S&P 500 ETF	-0.9	21.6	6.8
Castlefield CFP SDL UK Buffettology Fund	-0.4	12.1	2.7
Scottish Mortgage Investment Trust	-5.7	11.9	-4.9
FTSE All-Share – Total Return	-4.3	10.0	-2.0

Source: SharePad

So far, 2019 has proven to be a relatively easy year for investors to make money. Those who have invested in the shares of very good businesses outside the UK have received a bit of help from the falling pound and they have performed best.

The depreciation of sterling has added about 500 basis points to the total returns of a UK investor holding an S&P 500 ETF, compared with the performance of the index itself. It is therefore no surprise to see global funds with a high US equity exposure doing very well.

It has been more tricky for UK investors where the FTSE All-Share Index has delivered total returns of 10 per cent

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year to date. Even very good fund managers such as Keith Ashworth Lord has seen his UK Buffettology fund struggle to beat the market, but it has once again done so.

In fact, this year UK investors have been better off not owning UK shares. **iShares Index linked Gilt ETF (LSE:INXG)** has returned 16.9 per cent so far. **ETFS Physical Gold (LSE:PHGP)** and **Physical Silver (LSE:PHSP)** have returned 21.8 per cent and 15.1 per cent, respectively. A very cheap S&P 500 ETF has trounced most UK stock market funds, as it has done for many years with year-to-date returns of 21.6 per cent.

What I remain utterly convinced of is that if you are going to own individual shares, own the shares of outstanding businesses. You might be paying too much in the short run, but for those with a long-term or permanent owning perspective you are likely to sleep better at night than those hoping for a cheaper, inferior business to become more expensive. The performance of the funds listed above go a long way to supporting this view.

Noteworthy company results have been a little thin on the ground this week, so I have restricted myself to looking at just two. You can also hear more of my thoughts by listening to the Investors Chronicle companies and markets podcast.



Greene King

Monday afternoon's bid for **Greene King (GNK)** at 850p per share caught many – including me – by surprise.

Greene King, like many pub companies, has been struggling for some time to grow its sales, while battling with rising labour costs and business rates. Consequently, profits growth has been somewhat elusive and had been expected to be so for some time.

Back in May, the company announced that sales growth had picked up a bit, but not to the extent that would get analysts to revise their profit forecasts. In my weekly update of 3 May, I said I had a bit of a soft spot for Greene King due to the good locations of many of its pubs in more affluent parts of England and saw the shares as being reasonably attractive to income-seekers.

However, that's where my enthusiasm for the shares ended. I started my career as a pubs analyst over 20 years ago and have struggled to really warm to the sector. There has always seemed to be too many pubs and bars chasing too few customers. The millions of pounds that have poured into big managed pubs have made very modest returns for shareholders when looking at the profits and cash flows that have been generated from them.

The main saving grace from this strategy has come to companies that own the freeholds of their pub properties.

This has allowed them to close underperforming pubs and sell them to other pub companies or to property developers and raise meaningful amounts of cash flow to pay dividends in the meantime.

The property angle is being cited by many as the reason for the bid by CK Assets Holdings, an investment company owned by Hong-Kong billionaire Li Ka-shing. I am not too sure about this as Greene King has already secured a lot of debt against its property assets, in particular, its portfolio of 1,140 tenanted pubs.

At the end of April 2019, Greene King had £3.5bn tangible fixed assets on its balance sheet and just over £2bn of borrowings. Last year it paid out £118m in interest costs which equated to just over a quarter of the company's operating cash flow. Therefore, there does seem to be some scope to leverage the business a little bit more, this would increase the financial risks, but probably to levels that one of Hong Kong's richest men wouldn't lose any sleep about.

One of the best ways to look at the price paid for any acquisition is to look at the starting rate of return on investment. There are a couple of ways to do this. The first is to look at the return to the business or enterprise as a whole. CK is paying £4.6bn for all of Greene King's assets – its enterprise value – and is getting a business making £365m of trading profits – a pre-tax return of 7.7 per cent.

Another way is to look at the return on equity paid. CK is paying £2.64bn for all the equity of Greene King and getting just under £200m of post tax profits – a starting return on equity of 7.6 per cent.

These aren't stellar returns, but are fairly typical of many acquisitions of traditional established companies. To me, it also signals that CK are paying a very fair price for Greene King. I don't think the shareholders are being shortchanged here.

The returns are a lot better that you can get on bonds and cash and as long as the profits hold up the buyers – who own a portfolio of similar mature assets – will probably be reasonably happy. The key issue is whether the profits will hold up as running pubs only looks like it's going to stay a tough business.

If you are a shareholder in Greene King you couldn't care less. The future risks and rewards of the business have been taken away from you. What I do think is relevant is whether other UK-listed companies with similar assets and cash flow characteristics could become takeover targets in time.

I'm sure that other quoted pub operators with substantial freehold assets will be looked at. Fuller, Smith & Turner has some excellent freehold assets in London and

the south of England. Marstons and Mitchells & Butlers are arguably less attractive and are heavily indebted and this might put potential bidders off. Tim Martin's large shareholding in JD Wetherspoon means that a takeover for it is unlikely in my view.

It was interesting to see Sainsbury's shares on the FTSE 100 leaderboards the morning after the Greene King bid. It had some broadly encouraging market share performance announced this week but its freehold assets and low valuation – it trades at a 50 per cent discount to its net asset value – have seen it regularly discussed as a takeover target.

All things are possible of course, but I wouldn't hold my breath on this. The Qatari's have held over 20 per cent of Sainsbury's for many years now and haven't made a bid yet. There is also some doubt on the sustainability of Sainsbury's profits. It is currently using a lot of vouchers to woo shoppers which may have accounted for its sales holding up better than the other big supermarkets in recent weeks, but might not have helped its profits that much.

What I find most intriguing about this week's bid for Greene King is whether it might trigger a resurgence in value investing. The UK stock market is littered with companies that might not be classed as outstanding, but are fairly solid and available for reasonably cheap valuations, particularly to foreign investors.

I could find something – or plenty – wrong with the companies listed below, but they are cheap and it wouldn't surprise me if one or more of them was to receive a takeover approach.

Name	Market cap (m)	Close	ROCE	EBIT margin	PE roll 1
BT Group	15950	161.4	10	16.4	6.5
ITV	4615	114.65	20.7	18.3	8.7
Cineworld Group	3189	232.5	10.2	12.3	8.7
WPP Group	12119	960.4	10	13.1	9.6
Ashtead Group	10041	2174	19.6	31.5	10.3
lbstock	865	211.4	13.3	22.3	10.6

Source: SharePad



Persimmon

Persimmon (PSN) is trying to clean itself up. After paying an obscene bonus to its former chief executive for riding the wave of the Help to Buy (HTB) scheme – and not much else – and treating its customers shabbily it went to great lengths this week to explain to people how it was trying to be good.

This was the main reason why it did not report an increase in half-year profits this week. Its stock of work in progress surged by 19 per cent and it promised to spend lots of money on customer care.

Despite a lack of profits growth, Persimmon remains supremely profitable. It sold just under 500 fewer homes than in the first half of last year (7,584 versus 8,072) and its revenues were down by just under 5 per cent, but its profit margin on new-build homes went up from 29.7 per cent to 31.0 per cent. Yes, this was lower than the 31.8 per cent achieved during the second half of last year, but it is still evident of how much money this company is making from building and selling houses.

I am generally becoming more questioning of companies that make very high profit margins, as I wonder whether it is a sign of something that is unsustainable or something that will attract the attention of competitors, regulators or the government.

Persimmon makes high margins for many reasons. It has scale as one of the country's biggest builders, but also seems to be benefiting from some very fortuitous land buying. Land costs as a percentage of revenues fell from 15 per cent last year to 13.9 per cent this year.

There is no doubt that a big factor behind Persimmon's profit margins is that it has been the biggest beneficiary of the government's Help to Buy scheme. Fifty two per cent of its sales during the first half of the year were to first-time buyers (presumably on HTB).

These 20 per cent equity loans (40 per cent in London) have put money into buyers' pockets and pushed up new-build premiums to record levels of around 15 per cent, compared with equivalent existing properties nearby. Essentially, this scheme has lined the pockets of builders such as Persimmon. HTB is due to end in April 2023 when hopefully it will be replaced with something that is better equipped to deal with the country's housing issues.

These margins cannot last. Throw in the fact that growth in average selling prices is stalling and it's not difficult to say that things are unlikely to get much better for Persimmon. The company seems to have taken this view as well and is moderating its land purchases.

The good news is that investors don't expect the good times to last.

UK housebuilders

Company	Close	ROE	NAV ps	Price to NAV	PE roll 1	fc Yield	ROCE	EBIT margin	fc EBIT margin
Redrow	560	22.7	421.1	1.3	6.1	9.1	23.8	20.3	19.3
Bellway	2876	21.9	2079.3	1.4	6.6	5.1	26.3	22.2	21
Persimmon	1900	28	1006	1.9	7	12.4	31.1	29.5	29.1
Taylor Wimpey	147.55	21.8	98.4	1.5	7.2	12.4	21.2	20.4	20
Crest Nicholson Holdings	350.8	16.8	342	1	7.2	9.4	16.8	16.8	14.5
Barratt Developments	628	15.1	452.5	1.4	8.9	7.3	17	18.1	18.5
Bovis Homes Group	1032	12.9	787.2	1.3	8.9	9.9	14.2	16.5	17.2
Berkeley Group Holdings (The)	3870	22.6	2296.9	1.7	11.6	5.4	24.6	26.5	24
Telford Homes	349	13.9	332.6	1	12.2	4.9	11.8	12.4	7.7
MJ Gleeson	850	16.9	344.6	2.5	12.8	4	19.9	18.7	17.5
McCarthy & Stone	135.5	6.6	141.6	1	13	4	8	9.4	9.5

Source: SharePad

Many businesses with the kind of profitability being delivered by builders are trading on PE ratios of 20 or more in the current stock market. Yet builders trade in many instances on single-digit PEs and are paying big dividends.

There is no froth here, but it seems there is a lot of fear. I loathe the Help to Buy scheme and the crony capitalism it represents, but it is not going away just yet. We will get a recession one day, but it's hard to see how a very bleak future hasn't been priced into many shares.

What is fascinating is how these high profit margins are not being competed away by the price of land being bid up. Persimmon has mentioned that competition for smaller parcels of land has increased, but the big builders seem to be free to enjoy the spoils on big developments. The last recession saw a lot of small builders go to the wall or bought up by big players. As a result, big builders now have huge market power in land-buying and have been making hay from it for a long while now. This is unlikely to change.

It is always important to recognise that builders always work backwards from expected selling prices and build costs when buying land. They always target a margin of at least 20 per cent to protect themselves against poor markets. The achieved margins are then determined by actual selling prices.

Unless competition increases, margins are likely to stay high, but the absolute levels of profits will change depending on the buoyancy or otherwise of the local market.

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