investors CHRONICLE alpha

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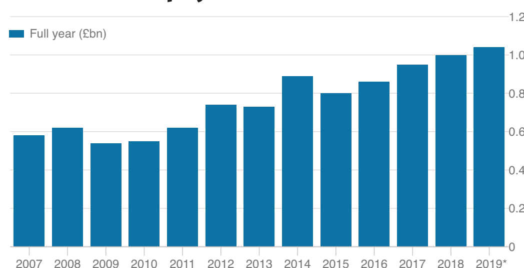
Phil Oakley's Weekly Round-Up

Investing in shares is all about the income a company generates – expressed as profits or cash flow – and people's expectations of how this will change in the future. Working on this principle, this week I assess the case for seven companies' shares

The companies mentioned this week are:

- Connect Group
- Strix Group
- AJ Bell
- JD Wetherspoon
- WH Smith
- Pets at Home
- easyJet

UK dividend payouts near £100bn



*2019 estimate
Source: Link Asset Services

Who needs income? – everyone does

One of the most frequent debates in investing is whether investing for income is something you should do. The simple answer is yes, because many people rely on the income provided from their investment portfolio to live on. With rates on bonds and savings accounts offering little in the way of interest, many income-seekers have turned to shares. So what's the best way to go about it?

Managers of growth funds often point out that buying shares with high dividend yields leads you into mature, slow-growing companies, or even worse, value traps. Instead of trying to live off dividend income, investors should buy a growth fund invested in high quality businesses instead and sell shares when they need some money.

I've a reasonable amount of sympathy with this view, but don't totally agree with it.

For me, all investing is about income. The income that a company generates – expressed as profits or cash flow – and people's expectations of how much it will produce in the future determines the value of most financial assets. The problem with buying growth funds is that the expectations of future income growth of the shares in it

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can be too high – the shares are overvalued. Investing in such a fund with the intention of drawing funds from it to pay for stuff is therefore no free lunch and could see substantial capital losses if overvalued shares fall significantly in price.

The same fate can await high dividend-paying blue-chips in the event of a market correction, but unless the dividend payout is cut, the downside is often less severe.

This brings me nicely onto the subject of the FTSE 100 index. In price terms, it is below the levels seen at the top of the tech boom at the end of 1999. But in income terms it looks quite attractive. The index is dominated by big mature dividend-paying companies such as HSBC, Shell, BP, GlaxoSmithKline, British American Tobacco, AstraZeneca, Diageo, Unilever and Rio Tinto.

Of course, these companies could cut their dividends or not grow them by very much. According to SharePad, 35 FTSE 100 constituents have forecast dividend yields of more than 5 per cent, with 46 having yields of more than 4 per cent. The index as a whole yields 4.6 per cent on a trailing basis.

I'm not predicting that the FTSE 100 is going to make you a lot of money from capital gains, but it does look like a good proxy for a diverse income fund for those needing a source of income to live on, with the usual risks of capital losses attached.

Jack Bogle, founder of the Vanguard Index Fund business, died just over a week ago having done a great deal to make stock market investing cheap and accessible for everyone. Thanks to Mr Bogle, you can buy the **Vanguard FTSE 100 ETF (VUKE)** for an annual ongoing charge of just 0.09 per cent without paying stamp duty or expensive platform charges. Why would you want to buy an expensive managed income fund?

Connect Group

This is a company that has always had to run hard to stand still. Its core business of distributing newspapers and magazines has been in long-term decline for many years. Yet, **Connect (CNCT)** has been very good at becoming more efficient and cutting costs to preserve the absolute level of profits from this business.

Its attempts to diversify and grow have been disastrous. In purchasing Tuffnells Parcels, it got its hands on a troubled business with poor quality revenue streams and a very managed cost base. When these characteristics were mixed with higher levels of debt, a deterioration in trading wreaked havoc.

Connect is trying to sort itself out, but I think it is unlikely that the company can regain the trust of inves-

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tors any time soon. The news distribution business still remains good at coping with declining sales and cutting costs, but Tuffnells still gives a lot of cause for concern in my opinion.

Tuffnells' sales for the first 19 weeks of the 2018-19 financial year have fallen by 8.8 per cent which, given the relatively high fixed cost base of this business, does not bode well for profitability in the short term. The company has said that the quality of its sales is getting better and that the business is currently operating at around cash flow breakeven position with the hope of getting back into profit during the second half of the year.

An amount of £35m has been raised from the sale and leaseback of 16 freehold properties at Tuffnells, but I'm not sure that this does much good. While this raises cash flow, the future rental commitments will offset this and might even increase the fixed costs and operational gearing of the business, making profits even more sensitive to changes in sales and more risky.

In reality, not much has changed at Connect in recent months. It still remains a declining revenue business with wafer-thin margins and too much debt. The forecast one-year rolling PE of five times at the share price of 41.6p may look very cheap, but it is with good reason in my opinion. There is also insufficient dividend yield to entice investors for the risks that they face.

Connect Group PLC (CNCT)

FORECASTS £ millions unless stated

Year	2019		2020		2021	
Turnover	1,472.0	-4.1%	1,435.9	-2.5%	1,392.0	-3.1%
EBITDA	44.7	-2.3%	45.9	+2.6%	46.9	+2.2%
EBIT	30.6	+19.1%	31.4	+2.8%	32.5	+3.3%
Pre-tax profit	24.8	+19.4%	26.2	+5.6%	27.7	+5.7%
Post-tax profit	20.3	-11.3%	22.1	+8.9%	23.6	+6.6%
EPS (p)	8.2	-11.8%	8.7	+6.1%	9.2	+5.7%
Dividend (p)	1.5	-51.6%	1.5	0.0%	1.5	0.0%
CAPEX	11.0	+29.4%	11.0	0.0%	11.0	0.0%
Free cash flow	27.0	-15.4%	25.0	-7.4%	26.0	+4.0%
Net borrowing	80.3	-3.5%	73.4	-8.7%	63.9	-12.9%

Source: SharePad

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Strix Group

If I said to you that you could buy shares in a business with profit margins of more than 30 per cent and a return on capital employed (ROCE) of nearly 20 per cent for less than 10 times its next year's forecast earnings, you'd probably take a look at it. You might also ask, what's the catch? – given that similar businesses with similar financial performances tend to trade at much higher valuations.

This is what investors are facing when looking at **Strix (KETL)**, a market-leading designer, maker and supplier of kettle safety controls and a growing water filtration products business.

Strix is a share that my colleague Simon Thompson has been keen on since the company floated on the Alternative Investment Market (Aim) back in 2017. I don't disagree with him that there's a reasonable amount to like with this business.

It has a stable market share (38 per cent) of a growing global kettle controls business and is becoming more efficient in manufacturing from its Chinese factories, where increased automation is supporting its high profit margins. It arguably needs to improve efficiency, as while global kettle volumes increased by 7 per cent in 2018, Strix's sales are expected to grow by less than that. This suggests there may be some pricing pressure or a change in sales mix before the impact of currency is taken into account.

The Aqua Optima water filter business is growing nicely and has built up a market share of 25 per cent in the UK branded and private label market, with the potential to grow sales overseas.

Strix remains a good cash generator and has made good progress in reducing its net borrowings to £28m, which is below current market expectations and underpins the company's intention to pay a total dividend of 7p per share for 2018.

Strix Group PLC (KETL)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	94.2	+3.2%	97.7	+3.7%	101.6	+4.0%
EBITDA	36.1	+2.9%	37.8	+4.5%	39.0	+3.2%
EBIT	30.3	+4.6%	32.2	+6.2%	33.2	+3.1%
Pre-tax profit	28.6	+1.0%	30.8	+7.7%	31.8	+3.2%
Post-tax profit	27.4	-0.3%	29.6	+8.0%	30.3	+2.1%
EPS (p)	13.8	-3.0%	14.8	+7.6%	15.3	+3.0%
Dividend (p)	6.9	+138.9%	7.5	+8.9%	7.9	+4.7%
CAPEX	6.2	+3.9%	9.4	+50.8%	9.1	-3.4%
Free cash flow	21.0	-23.1%	22.8	+8.6%	23.5	+2.7%
Net borrowing	33.0	-28.0%	24.3	-26.4%	10.5	-56.7%

Source: SharePad

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Despite reassuring news on its trading performance, Strix's volatile share price performance suggests that investors are far from convinced on the sustainability of the company's profits. It is a basic rule of economics that high profit margins tend to attract competition and that successful companies need something to keep competition at bay.

Strix has patents that are there to protect its intellectual property, but it has had to work hard to enforce these in instances where companies have copied its products. While the company has been compensated for the misdemeanour of others, competition and patent expiry remain a real risk to Strix's ability to maintain its high levels of profitability in the future, in my view.

That said, the current valuation of the shares is far from excessive and suggests that expectations of future profits growth are pretty modest. A 2019 forecast dividend yield of 5.2 per cent at the current share price of 144p is also supportive.

AJ Bell

Investment platform **AJ Bell (AJB)** only listed on the stock market last month, but its shares have gone up significantly since then. The company has announced a reassuring first-quarter trading update this week. Although falling stock markets led to assets under management declining 4 per cent since September 2018 (to £44.2bn), there were new inflows of £1.2bn in investor capital. This is a decent performance, but it should remind investors that the profitability of platforms is also highly dependent on the direction of stock markets.

From a customer's perspective, I am a fan of AJ Bell. I like its platform and find it easy to use. Its internet-dealing services are good as is its customer service. The annual costs of managing Sipps (self-invested personal pensions), Isas (individual savings accounts) and Junior Isas are very low and good value in my opinion.

AJ Bell PLC (AJB)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	104.0	+16.0%	119.0	+14.4%	134.0	+12.6%
EBITDA	40.0	+31.8%	48.0	+20.0%	56.0	+16.7%
EBIT	38.0	+33.9%	46.0	+21.1%	54.0	+17.4%
Pre-tax profit	-		-		-	
Post-tax profit	31.0	+36.9%	38.0	+22.6%	44.0	+15.8%
EPS (p)	7.4	+32.1%	9.1	+23.0%	10.7	+17.6%
Dividend (p)	5.7		7.4	+29.8%	8.7	+17.6%
CAPEX	1.0	+4.5%	1.5	+50.0%	1.5	0.0%
Free cash flow	30.1	+7.4%	38.1	+26.6%	44.6	+17.1%
Net borrowing	-65.0		-78.0		-91.0	

Source: SharePad

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I'm less convinced from an investor's perspective. Apart from allowing existing stakeholders selling their shares to cash in, I'm not sure why this company needs to be listed on the stock exchange and don't really buy into the publicity side of it.

AJ Bell will aim to grow by wooing customers from other platforms as the growth from defined benefit pension scheme transfers is petering out. I am not convinced that it can take much business from **Hargreaves Lansdown (HL.)** despite its lower charges, but I think its high profit margins are relatively safe for now.

My concerns with platforms is that their profitability is very dependent on the fees they charge on open-ended funds. The 0.25 per cent charged by AJ Bell on amounts invested in funds up to £250,000 is cheaper than Hargreaves Landsdown's (0.45 per cent), but would still cost the investor up to £625 per year in platform charges.

An investor with a portfolio invested in shares, investment trusts or ETFs (exchange traded funds) would pay £100. I think this is price discrimination which treats the investor in funds unfairly, compared with investors who choose to invest in other ways. It would not surprise me if these charges come under increasing scrutiny, as it is very hard to see how they are justified. Should these fees come down, then AJ Bell's and Hargreaves' profit margins could come under significant pressure.

I think AJ Bell shares are not pricing in any regulatory or stock market risk. They look very expensive on a one-year rolling forecast PE of 35.9 times at a share price of 285p and a reasonable premium to Hargreaves Lansdown, which trades on 31.9 times at the time of writing.

JD Wetherspoon

JD Wetherspoon's (JDW) pubs and the political views of its founder and chairman may not be to everyone's taste, but it cannot be doubted that the company is a very good operator. It continues to deliver sector-leading like-for-like (LFL) sales growth against very tough comparatives from last year.

LFL sales in the 12 weeks to 20 January increased by an impressive 7.2 per cent. Year-to-date LFL sales (25 weeks) are up by 6.3 per cent. This is a very impressive performance considering that LFL sales a year ago for the comparable periods were increasing by 6 per cent. This shows that the company's strategy of offering affordable drinks and food continues to appeal to an increasing number of consumers.

Despite the impressive sales performance, higher labour costs along with higher utilities, interest, repairs and depreciation costs means that half-year profits will be

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lower than last year's and that expectations for full-year profits are unchanged.

Wetherspoon (JD) PLC (JDW)
FORECASTS £ millions unless stated

Year	2019		2020		2021	
Turnover	1,768.8	+4.4%	1,834.8	+3.7%	1,904.0	+3.8%
EBITDA	216.3	+3.0%	223.0	+3.1%	230.6	+3.4%
EBIT	134.3	+2.7%	137.6	+2.4%	141.2	+2.6%
Pre-tax profit	101.2	-3.0%	103.8	+2.6%	107.8	+3.8%
Post-tax profit	78.6	-2.7%	80.7	+2.6%	83.5	+3.5%
EPS (p)	75.3	-1.6%	78.8	+4.6%	82.5	+4.7%
Dividend (p)	12.0	0.0%	12.1	+0.8%	12.2	+0.8%
CAPEX	93.2	+35.2%	94.9	+1.8%	91.0	-4.1%
Free cash flow	106.6	-0.8%	101.3	-5.0%	110.6	+9.2%
Net borrowing	697.7	-3.9%	655.7	-6.0%	619.1	-5.6%
NAV	-		-		-	
Like for like sales growth %	4.4		3.4	-22.7%	3.3	-2.0%

Source: SharePad

The company is continuing to buy the freeholds of pubs that it previously leased and expects to open between five and 10 new pubs this year. Despite this strategy, good cash generation means net borrowings are expected to be only £10m higher than last year and higher than current analysts' forecasts which were predicting a small decline.

The significance of JD Wetherspoon's trading update comes with the implications for the profits of weaker operators in the sector such as **Revolution Bars (RBG)** which I commented on last week. If Wetherspoon's cannot increase profits on the back of its LFL sales growth then what hope do weaker pub groups with stagnant or falling sales have? The risk of further downgrades to profit forecasts for such companies cannot be ruled out. The risk is that after a buoyant Christmas and New Year for the sector, customers will cut back in the early months of 2019.

For me, Wetherspoons remains the best pub operator in what remains a very difficult sector. A one-year rolling forecast PE of 15.5 times reflects that.

WH Smith

This week's trading update from **WH Smith (SMWH)** confirms that the company continues to trade well. The travel business continues to grow its LFL sales (+3 per cent for 20 weeks of 2018-19) and add new outlets in the UK and overseas. The strong sales momentum in the recently acquired InMotion business in US airports has continued.

Trading in the UK high street business has held up surprisingly well after a decent Christmas performance and a strong performance from stationary products. LFL sales fell by 2 per cent (they were down by 3 per cent for the whole of 2017-18), but gross profit margins increased. With the cost savings target on track, profit expectations in this business look to be holding up well.

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WH Smith PLC (SMWH)

FORECASTS £ millions unless stated

Year	2019		2020		2021	
Turnover	1,344.9	+6.6%	1,406.5	+4.6%	1,459.3	+3.7%
EBITDA	204.0	+10.8%	218.2	+7.0%	231.9	+6.3%
EBIT	159.3	+13.0%	169.9	+6.6%	181.6	+6.9%
Pre-tax profit	154.7	+11.3%	166.0	+7.4%	176.9	+6.5%
Post-tax profit	125.3	+5.3%	133.4	+6.4%	143.1	+7.3%
EPS (p)	115.0	+6.3%	125.1	+8.8%	135.6	+8.4%
Dividend (p)	57.5	+6.3%	62.2	+8.2%	67.4	+8.4%
CAPEX	52.2	-1.5%	52.6	+0.8%	55.3	+5.0%
Free cash flow	117.2	+30.2%	129.0	+10.1%	138.9	+7.7%
Net borrowing	167.0	+8250.0%	63.4	-62.0%	8.8	-86.1%

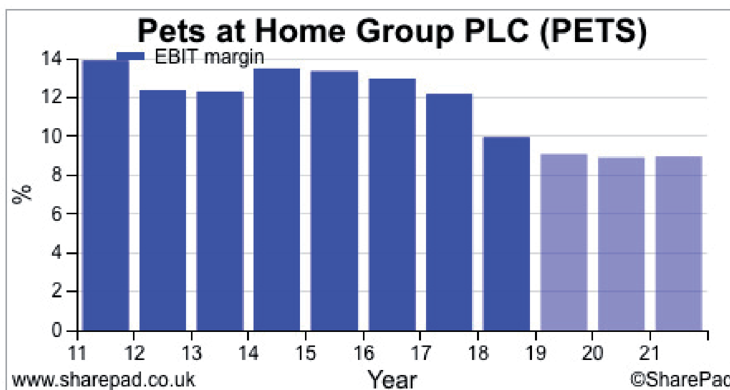
Source: SharePad

I continue to like WH Smith's travel business along with the company's strong free cash flow generation, ongoing share buyback and decent dividend growth. Despite the burden of carrying the high street stores, I think the long-term prospects for this company remain quite favourable. The shares, at 1,912p at the time of writing, trade on a one-year forecast rolling PE of 16 times, which doesn't look too stretched.

Pets at Home

Pets at Home (PETS) is a common example of an IPO from a private equity seller that goes badly. Too often, very little extra value is left on the table by the selling shareholder. The current share price of 142p at the time of writing is a long way below the 240p IPO price.

Pets has had to face up to the competitive challenges in its market place and its over-reliance on selling pet food as a source of profits. It has had to cut prices on pet food to compete with the likes of Amazon and Zooplus and move into pet services – such as grooming – and veterinary practices which have lower profit margins. This has seen its profit margins fall overall and makes it very hard to grow.



Source: SharePad

Sentiment towards the company and its shares has been poor. During the past year, consensus profit forecasts for

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2019 and 2020 have fallen by around 5 per cent and the valuation of Pets' shares has come down from just under 14 times one-year rolling forecast EPS to just under 11 times.

Pets at Home Group PLC (PETS)

FORECASTS £ millions unless stated

Year	2019		2020		2021	
Turnover	945.5	+5.2%	973.3	+2.9%	996.5	+2.4%
EBITDA	123.2	-0.1%	123.7	+0.5%	127.6	+3.1%
EBIT	85.9	-4.0%	86.7	+0.9%	89.3	+3.0%
Pre-tax profit	81.6	-3.5%	82.4	+1.1%	86.9	+5.4%
Post-tax profit	67.0	-0.8%	68.0	+1.4%	70.6	+3.8%
EPS (p)	13.2	-1.5%	13.1	-0.8%	13.6	+3.8%
Dividend (p)	7.5	-0.0%	7.5	0.0%	7.5	0.0%
CAPEX	39.5	-5.1%	39.0	-1.3%	39.0	0.0%
Free cash flow	55.1	-11.4%	55.0	-0.2%	57.7	+5.0%
Net borrowing	126.1	-6.4%	111.8	-11.3%	85.4	-23.6%

Source: SharePad

This week there have been signs that perhaps the company might be turning a corner and on its way to better times ahead. Its third-quarter trading statement revealed that retail LFL sales were up by 4.7 per cent and veterinary LFL sales were up by 9.1 per cent. Pre-tax profits for the year to March are expected to be within the range of £80m-£85m.

As a regular buyer of cat food, I have made a very small contribution to the increase in the company's LFL sales. Considering myself to be a reasonably savvy buyer of most things, I have recently switched from Zooplus to Pets at Home due to its better range and much improved prices. Its website is easy to use as well.

Yet, I struggle to see Pets at Home as a business that is capable of meaningful and sustainable sales and profits growth. Nor do I see it capable of earning very good returns on capital employed (7.3 per cent last year on a lease adjusted basis). But maybe it doesn't have to, given its low rating, a dividend yield of over 5 per cent and the ability to pay down debt. That said, I struggle to come up with a compelling reason to invest.

easyJet

Back in November, I suggested that **easyJet (EZJ)** shares might be cheap trading on a one-year forecast rolling PE of nine times and a prospective dividend yield of more than 5 per cent at a share price of 1,133p. The caveat being that this would only be the case if it could meet forecasts by getting its costs under control and weathering the fierce competition in its markets.

This week's first-quarter trading statement suggests that it is still on course to do this – just.

The good news was that passenger yields on an underlying basis were up slightly, but were down by 3.8 per cent due to the dilutive effect of its operations in Berlin.

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EasyJet seems to have achieved higher ticket prices at the expense of its planes flying slightly less full – load factor was down from 92.1 per cent to 89.7 per cent – while getting more ancillary income out of passengers.

Three months ended	31 Dec 2018	31 Dec 2017	Change Fav./(adv.)
Passengers (million) (1)	21.6	18.8	15.1%
Seats flown (million)	24.1	20.4	18.2%
Load factor (%) (3)	89.7%	92.1%	(2.4ppts)
Total revenue (GBP million)	1,296	1,140	13.7%
Passenger revenue (GBP million)	1,025	914	12.2%
Ancillary revenue (GBP million)	271	226	19.9%
Total revenue per seat reported (GBP)	53.89	55.99	(3.8%)
Total revenue per seat constant currency (GBP)	53.63	55.99	(4.2%)
Total headline cost per seat reported (GBP)	(56.71)	(54.34)	(4.3%)
Total headline cost per seat at constant currency (GBP)	(55.55)	(54.34)	(2.2%)
Headline cost per seat excluding fuel at constant currency (GBP)	(43.27)	(42.83)	(1.0%)
ASKs (million)	26.0	22.3	16.5%
RPKs (million)	23.5	20.7	13.6%

Source: Company report

There seems to be a bit of doubt as to whether the company can meet current analysts' forecast for the year to September when it says it currently expects them to be "broadly in line with expectations".

On the passenger yield front, first-half yields are expected to be down by mid to high single-digit percentages. Full-year capacity growth is expected to be 10 per cent (15 per cent in the first half and 5 per cent in the second half) with cost per seat, excluding fuel, expected to be flat. Fuel costs are looking better than they were three months ago, with the profit hit from higher costs expected to be in the range of £10m-£60m rather than £50m-£100m. There has been a small hit to profits from the drone disruption at Gatwick last month.

The yield outlook is where I am a little bit nervous. While capacity in key European markets seems to be quite disciplined at the moment, easyJet will not benefit from the bankruptcy of Monarch and the chaos at Ryanair that helped it last year. Higher-than-expected competition in Berlin means that easyJet will not make a profit

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this year, which it had expected to do.

I think easyJet ability to hit current analysts' forecasts has become tougher and will require it to have a good summer booking season. Load factors were high last year and will need to stay at similar levels.

The shares have started 2019 well and still look inexpensive on a forecast one-year rolling PE of 10 times and a prospective dividend yield of 5 per cent, but the risk of missing forecasts has increased, in my opinion. This could see the shares treading water for a while.

easyJet PLC (EZJ)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	6,549.9	+11.1%	7,088.1	+8.2%	7,613.8	+7.4%
EBITDA	846.5	+22.9%	921.6	+8.9%	1,018.5	+10.5%
EBIT	621.7	+30.9%	677.8	+9.0%	773.9	+14.2%
Pre-tax profit	580.8	+30.5%	626.2	+7.8%	709.6	+13.3%
Post-tax profit	470.5	+1.0%	501.1	+6.5%	550.7	+9.9%
EPS (p)	120.6	+2.7%	131.0	+8.6%	142.3	+8.6%
Dividend (p)	61.3	+4.6%	65.2	+6.4%	72.5	+11.2%
CAPEX	981.6	-3.0%	999.1	+1.8%	812.9	-18.6%
Free cash flow	-56.9		-103.4		502.5	
Net borrowing	91.7		543.1	+492.3%	342.3	-37.0%

Source: SharePad

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