investors CHRONICLE alpha

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Phil Oakley's Weekly Round-Up

It's noticeable how well a S&P 500 tracker has performed for UK investors this year, delivering good returns at a fraction of the cost of managed funds. My Fantasy Sipp is also holding up well against a selection of quality funds

The companies mentioned this week are:
- Forterra
- Smith & Nephew
- Bioventix
- Whitbread
- AJ Bell
- McDonald's

Fantasy Sipp performance

	Portfolio returns (%) 1 month	Year to date	1 year
Mid Wynd International Inv Trust	-3.1	22.5	18.2
Martin Currie Global Portfolio Trust	-2.12	22.4	18.8
Phil Oakley Fantasy Sipp	**-2.8**	**21.6**	**26**
Smithson Investment Trust	-3.15	20.1	15.7
Vanguard S&P 500 ETF	-2.64	19.6	11.8
Fundsmith Equity T Acc	-4.83	19.4	14.7
Finsbury Growth & Income Trust	-4.65	19.2	20.8
LF Blue Whale Growth Fund	-6.48	18.5	12.2
Lindsell Train Global Funds plc	-6.52	17.1	15.4
FTSE All-Share – Total Return	0.829	13.9	10.3
Castlefield CFP SDL UK Buffettology Fund	-2.06	12.7	9.73
Scottish Mortgage Investment Trust	-2.15	6.4	6.92

Source: SharePad

Despite taking a hit from Smith & Nephew and McDonald's over the past week, the Fantasy Sipp continues to hold up quite well against a collection of highly regarded quality funds and index tracking funds.

I can't help noticing how well a S&P 500 ETF fund is performing for UK investors so far this year. The Vanguard ETF has an ongoing charge of just 0.07 per cent and is doing just as good a job as many highly rated and touted

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managed funds with higher charges which also own a lot of US-listed shares.

Beating the stock market consistently is very hard to do. Yet many fund managers are making ludicrous amounts of money for trying to do so. This is largely a function of their asset-gathering business models, which rewards them handsomely for managing lots of other people's money.

Good performance attracts more money to manage and with each new customer comes another set of fees. Fees are then charged on this bigger pot of money and the fund managers become very rich in the process, especially when the stock markets in general are going up but also if the fund underperforms the market.

For example, Fundsmith – for me the best managed fund available to UK investors – had £18bn of money invested in it at the end of September 2019. Charging its 1 per cent fee on this gives £188m of annual income to the fund manager. The Vanguard S&P ETF would receive £13m on the same amount – a huge difference.

We need a radical change in the way that active fund managers are paid. In my opinion, they should only be paid for outperforming the market they are benchmarked against. If market performance costs just 0.1 per cent in a tracker then why should investors pay more for matching or underperforming it? Outperformance should be rewarded with a modest performance fee, but it should be subject to cumulative clawbacks so that one year's outperformance should not give outsized rewards and that underperformance can be penalised as well.

This is a similar approach to how Warren Buffett charged his customers between 1956 and 1969 when he ran an investment partnership. He did not get paid unless he made 4 per cent and he got to keep half of any performance above that 4 per cent. If he made less than 4 per cent then he did not get paid until he made it back. How many fund managers do you think would sign up for a charging structure like that or the one that I have suggested?

For those that did, they would not likely be working in swanky offices in London, but more likely to be in small offices above sandwich shops in provincial market towns.

This, of course, will never happen.

Forterra

I like brick-making businesses in the UK. This is because they are scarce assets in a market where demand has been running ahead of supply. Barriers to entry are high as ownership of substantial clay reserves gives companies a big source of competitive advantage. This kind of fundamental support allows a business such as **Forterra (FORT)** to make high profit margins and very decent re-

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turns on capital employed (ROCE).

Like the housebuilders who buy its bricks, Forterra is a cyclical business that will go through ups and downs. The key issue is will its customers buy more of its products for the foreseeable future.

This week's trading update casts a lot of doubt on whether this will be the case. From the beginning of July to the middle of October, Forterra's sales to housebuilders have been more or less what it expected but sales to distributors and non-residential customers has been weaker. As a result, it now expects pre-tax profits for the year to December 2019 will be modestly below last year's result of £64.8m.

What is of more concern in my view is what happens next year. Recent trading updates from housebuilders all point to them struggling to build more homes as the market gets tougher. The price of new build homes has become way too expensive – the so-called new build premium – relative to existing homes. I can certainly see this where I live in Essex, while people in the local building trade tell me that new homes are getting increasingly difficult to sell.

Builders will be reluctant to cut selling prices, which might begin to question the value of land they hold on their balance sheets. What they might try to do instead is slow down their build rates and hold back supply coming on to the market (as Persimmon has been doing). If this happens then demand for bricks is probably going to slow and may even decline for a while.

Forterra forecasts

		Year (£m)	
	2019	2020	2021
Turnover	379.7	392.3	404.8
Ebitda	82.5	86	89.7
Ebit	67.6	70.6	73.6
Pre-tax profit	63.9	67.1	70
Post-tax profit	53.1	55.9	57.8
EPS (p)	26.2	27.6	28.7
Dividend (p)	11.8	12.4	13
Capex	39.8	42.4	43.6
Free cash flow	34.3	40.4	32.6
Net borrowing	44.5	47	45

Source: SharePad

Given this backdrop, it's not very difficult to see profit forecasts coming down, the issue is by how much. If I interpret "modestly below" to mean around 5 per cent below last year then we may be looking at earnings per share (EPS) for Forterra of around 25p. At 275p, this puts the shares on 11 times earnings which does not look excessive to me. Cash generation remains good and this suggests that a dividend per share of 11.8p as currently forecast is not an unreasonable expectation and gives the shares a yield of 4.3 per cent.

Sentiment towards Forterra shares may be subdued for a while but a lot of the well placed caution towards its business looks to be priced in.

Smith & Nephew

How important is a company's chief executive? Given the reaction of **Smith & Nephew's (SN.)** share price on Monday this week to the announcement that its chief executive Namal Nawana was leaving you could be forgiven for thinking it is absolutely critical. The share price fell by 9 per cent on the day.

I hold a different view. I think far too much significance is given the chief executive of a business which has seen the rise of personality CEOs in recent years. Yes, a capable chief executive can do a lot of good and steer a business in the right direction. But this overlooks the fact that the success or otherwise of a business is generally due to the efforts of lots of people. Above all else, it is the company's products and services that will determine its success or otherwise.

For me, there is no way that Smith & Nephew's equity value was worth 9 per cent less than the day before due to the departure of one man. That's not to say that Mr Nawana has not had a positive influence on the business during his short term in charge, he has. The point is that the strategy of the business which is beginning to bear fruit remains in place under his replacement.

What is a little bit sad is that it seems that Mr Nawana's decision to leave was apparently due to a dispute over money. FTSE 100 chief executives are paid very well and have seen the gap between what they take home and that of the average worker soar over the past decade.

Nawana will now seek his riches elsewhere, but I welcome the fact that a board of directors has not bowed to pressure. Housebuilder MJ Gleeson booted out its chief executive in the summer after refusing to pay him more money and it has not harmed the business at all. I see no reason why Smith & Nephew should not continue to do well.

My decision to add Smith & Nephew to the Fantasy Sipp portfolio a few weeks ago looks ill-timed in the short run, but these things happen from time to time. I remain confident that this business has a decent future ahead of it.

Smith & Nephew forecasts

	Year ($m) 2019	2020	2021
Turnover	5,104.30	5,345.00	5,579.50
Ebitda	1,505.60	1,621.90	1,716.50
Ebit	1,147.90	1,222.40	1,302.00
Pre-tax profit	1,079.90	1,134.20	1,223.80
Post-tax profit	881.6	943	1,021.30
EPS (¢)	101	108.5	118
Dividend (p)	28.6	32.4	33.1
Capex	401.1	401.5	408.7
Free cash flow	716.9	828.1	1,081.30
Net borrowing	1,669.10	1,388.10	1,025.50

Source: SharePad

Bioventix

Bioventix (BVXP) is one of the most profitable businesses on the London market. From a small laboratory in Surrey with just a few employees, it sells its sheep monoclonal antibodies to health care companies across the world which are then used in their blood testing machines in hospitals. The antibodies are used to test for things such as signs of heart disease, thyroid problems, fertility and cancer.

Bioventix's antibodies have been popular with its customers as they have been seen to give better performances than other antibody products. Yet, it only sells 10 grammes of physical antibody product per year. Seventy per cent of its revenues comes from royalty payments from its customers who use its antibodies to sell diagnostic products.

These royalty revenues are essentially pure profit and can be seen in the company's financial results. Underlying revenues for the year to June 2019 increased by 6 per cent to £9.3m, but higher costs saw pre-tax profits increase by just 1 per cent to £7m – still an impressive profit margin of 75.3 per cent.

Its most significant revenue source which accounts for nearly half the company's revenues – a vitamin D antibody – had a good year with 27 per cent growth, but there are signs that demand may have peaked due to competition.

The big hope for Bioventix and its investors is that significant future growth comes from its troponin antibody which will be used by Siemens in its diagnostic machines. This antibody can allow doctors to quickly tell if someone has had a heart attack or not and can rapidly speed up the treatment process for patients or let them go home without taking up hospital beds. £120,000 of sales came from troponin last year, but the company is still confident that eventually this will have a significant positive effect on the business.

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The company is paying out its surplus cash to shareholders with a total dividend of 73p per share for 2019 and a special dividend of 47p per share. If troponin takes off then the expectation of more special dividends is not unreasonable.

Bioventix shares have had a lacklustre 2019 having peaked at over £40 per share in April. At 3,150p, the shares have been derated to 25 times forecast earnings. The timing and scale of troponin sales are uncertain whilst the tailing off of vitamin D sales is a concern. That said, any growth in revenues is going to see most of it end up in shareholders' pockets. Patient investors may see an opportunity after the recent share price dip.

Bioventix forecasts

Year (£m)	2020	2021
Turnover	10.1	11.1
Ebitda	7.9	8.7
Ebit	7.8	8.5
Pre-tax profit	7.8	8.6
Post-tax profit	6.5	7.2
EPS (p)	124.8	136.8
Dividend (p)	88	98
Capex	0.3	0.1
Free cash flow	5.9	6.7
Net borrowing	-5.9	-7.9

Source: SharePad

Whitbread

Whitbread (WTB) needs shaking up in my opinion. Yet its management seem to be quite happy to soldier on continuing with what it has been doing.

For years the company was badgered by investors to spin off Costa Coffee before eventually being the beneficiary of a very generous takeover bid for the business from Coca-Cola last year. It now seems to be dragging its feet over Premier Inn as well.

Having stayed in a few Premier Inns over the years, I'd say it is a good business with a good product. From an investor's perspective, I'm not sure that Whitbread is getting the most out of these assets.

At the moment, things are going too well in its core UK business whereas losses in Germany are going up in its early ventures there.

In the UK, it seems that the market can be summed up as too many hotel rooms chasing too few customers, especially outside London.

Premier Inn UK estate metrics

	H1 FY20	H1 FY19	*Change*
# hotels	810	795	*1.9%*
# rooms	76,837	74,070	*3.7%*
Direct booking	98%	97%	*100bps*
Occupancy	78.3%	80.1%	*(180)bps*
Average room rate	£64.07	£66.16	*(3.2)%*
Revenue per available room†	£50.19	£52.97	*(5.2)%*
Total accommodation sales growth	(0.6)%	4.8%	
Like-for-like accommodation sales growth	(3.6)%	0.2%	
Total food & beverage sales growth	0.6%	(0.8)%	
Like-for-like food & beverage sales growth	(1.2)%	(2.6)%	
UK return on capital	12.1%	13.3%	*(120)bps*
Committed pipeline (rooms)	12,928	13,385	

Source: Whitbread

All the key performance measures are going in the wrong direction during Whitbread's half year. Occupancy is down as are room rates, which led to a 5.2 per cent fall in the closely watched revenue per available room (RevPAR). ROCE has also fallen sharply. Profit before tax declined by 4 per cent to £236m, with an unchanged dividend per share of 32.7p.

Given an uncertain outlook, it's difficult to see things getting better soon.

I've long believed that Whitbread should shift from being an asset owner to a franchisor as **Intercontinental Hotels (IHG)** has done so successfully. Two-thirds of the company's Premier Inns are freehold and the value of these could be paid out to shareholders and replaced with an asset light, cash-generative franchise business model.

Whitbread shows no interest in doing this. But if it did, I would hope that any cash would be paid out to shareholders in dividends rather than a share buyback. Whitbread's £2.5bn buyback from the Costa sales proceeds has been a disaster for shareholders. The £2bn tender for shares in July this year bought shares at an average price of 4,972p each. Compare this with the current share price of 4,159p and shareholders can justifiably ask how this exercise has made them better off.

Shareholders who sold their shares to the company will probably be happy enough in hindsight, but a long-term investor in the business who held onto their shares has received little benefit in terms of total returns.

I think Whitbread remains vulnerable to a takeover bid while it sits on its substantial freehold property assets, even though it is trading on quite a full valuation of 19.5 times 2020F EPS. Current forecasts look too high to me given the trading backdrop.

Whitbread forecasts

		Year (£m)	
	2020	2021	2022
Turnover	2,064.30	2,189.50	2,298.30
Ebitda	767	800.6	851.3
Ebit	509.5	535.8	562.6
Pre-tax profit	385.8	408.7	434.6
Post-tax profit	315.2	334.7	351.9
EPS (p)	211.9	247.3	264.7
Dividend (p)	95.6	102.5	108.7
Capex	539.3	569.8	587.4
Free cash flow	4.9	56	67.3
Net borrowing	2,660.80	2,876.80	3,127.60
NAV	3,820.30	3,979.30	4,393.00
Like for like sales growth (%)	-1.2	1.1	1.6

Source: SharePad

AJ Bell

Once they have enough customers and with it, enough fee income, investment platforms can become extremely profitable business if they keep on getting more people to sign up. Hargreaves Lansdown (HL) has proven this with bells on and it looks as if **AJ Bell (AJB)** is following suit.

The year 2019 has been a good one for AJ Bell. It has attracted nearly 35,000 new customers to its investment platform and has grown its assets under administration (AUA) by £6.2bn to £52.3bn with a bit of help from rising stock markets. It remains around half the size of the market leader Hargreaves Lansdown on this measure.

Year ended 30 September 2019	Advised Platform £billion	D2C Platform £billion	**Total Platform £billion**	Non-platform £billion	**Total £billion**
Opening AUA	29.9	8.7	**38.6**	7.5	**46.1**
Underlying inflows(1)	3.4	2.0	**5.4**	0.1	**5.5**
Outflows(2)	(1.6)	(0.6)	**(2.2)**	(0.5)	**(2.7)**
Underlying net inflows/(outflows)	1.8	1.4	**3.2**	(0.4)	**2.8**
DB inflows(3)	0.9	-	**0.9**	-	**0.9**
Migration inflows(4)	-	0.2	**0.2**	-	**0.2**
Total net inflows/(outflows)	2.7	1.6	**4.3**	(0.4)	**3.9**
Market and other movements(5)	1.2	0.8	**2.0**	0.3	**2.3**
Closing AUA	33.8	11.1	**44.9**	7.4	**52.3**
Customers	98,056	120,113	**218,169**	13,897	**232,066**

Source: AJ Bell

Unlike HL, AJB does not give a breakdown of its revenues by investment type. It is a beneficiary of the fees on open ended managed funds – which I see as being way too high relative to fees on other investments – but not to the same extent as HL.

If AJB meets current forecasts – this week's trading statement suggests it will – then its profit margins will be over 36 per cent for 2019, up from 31.6 per cent last year. As long as markets hold up, margins are expected to hit 40 per cent by 2021. This is still some way behind HL's

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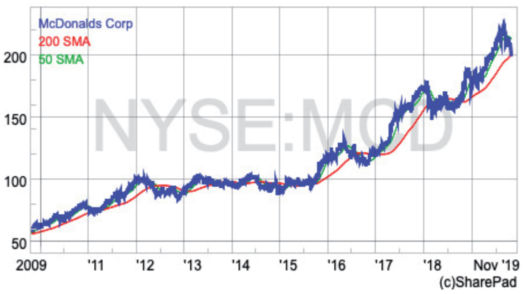
64 per cent, but impressive nonetheless.

AJ Bell forecasts

	Year (£m) 2019	2020	2021
Turnover	104.10	117.60	130.4
Ebitda	39.90	46.20	52.8
Ebit	38.10	44.30	50.9
Pre-tax profit	37.70	43.80	50.7
Post-tax profit	30.60	36.80	42.7
EPS (p)	7.50	9.00	10.5
Dividend (p)	4.9	5.9	8.7
Capex	1.00	1.50	1.5
Free cash flow	29.60	37.30	42.7
Net borrowing	-60.00	-74.00	-87.7

Source: SharePad

The benefits of increasing scale should feed through into very strong levels of earnings and dividend growth, but most of this looks to be priced into the shares and then some. The shares have soared since listing in December, but at 378p I struggle to see value when they trade on a 2020 forecast PE of 42 times, while offering a dividend yield of just 1.6 per cent.



McDonald's

I added **McDonald's (NYSE:MCD)** to the Fantasy Sipp portfolio in February this year. It has performed quite well giving a total return of 13.9 per cent.

The reason for its inclusion was its ability to keep growing its revenues modestly, while shifting the mix of its stores to more profitable franchises away from company owned stores. With excellent profit margins and high returns on capital, my view was that this was a company was capable of compounding in value and helping this process by continuing to buy back its own shares.

This week's third-quarter results can only be described as disappointing, as both revenues and profits came in below the expectations of Wall Street analysts. Revenues increased by just 1 per cent, operating profit was unchanged and net profits fell by 2 per cent. The ongoing buyback mean that EPS was unchanged at $2.11. One bit of good news was that the quarterly dividend was increased by 8 per cent to $1.25 per share.

That said, when I dig a bit deeper into the numbers, I find some encouraging signs. The business is still producing decent levels of comparable sales growth, particularly in international markets.

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COMPARABLE SALES

	Increase/(Decrease)			
	Quarters Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
U.S.	4.8%	2.4%	5.0%	2.6%
International Operated Markets	5.6	5.7	6.1	6.2
International Developmental Licensed Markets & Corporate	8.1	5.1	7.3	5.5
Total	5.9%	4.2%	5.9%	4.5%

Source: McDonald's

The move to franchising also continues to bear fruit with profits growing and margins staying above 80 per cent. Again, the company's International businesses have performed well here.

Restaurant Margins

FRANCHISED AND COMPANY-OPERATED RESTAURANT MARGINS
Dollars in millions

Quarters Ended September 30,	Percent 2019	Percent 2018	Amount 2019	Amount 2018	Inc/ (Dec)	Inc/ (Dec) Excluding Currency Translation
*Franchised **						
U.S.	78.8%	81.5%	$ 1,076.2	$ 1,052.9	2 %	2 %
International Operated Markets	80.2	80.1	1,063.1	1,015.2	5	9
International Developmental Licensed Markets & Corporate	97.8	97.3	315.2	290.9	8	11
Total	81.4%	82.5%	$ 2,454.5	$ 2,359.0	4 %	6 %
Company-operated						
U.S.	15.6%	12.8%	$ 97.8	$ 81.3	20 %	20 %
International Operated Markets	21.3	21.9	348.8	371.3	(6)	(3)
International Developmental Licensed Markets & Corporate	n/m	n/m	n/m	n/m	n/m	n/m
Total	18.6%	18.4%	$ 448.9	$ 463.1	(3)%	(1)%

Source: McDonald's

I am keeping faith with this business, despite a modest set of results this week. This is a business that continues to have mass appeal whilst offering outstanding value compared with many of its competitors. It is innovating into healthier menu choices and non-meat products, while picking up additional sales in the breakfast trade and areas such as coffee.

McDonald's forecasts

	Year ($m) 2019	2020	2021
Turnover	21,026.90	21,660.40	22,311.10
Ebitda	10,712.50	11,320.00	11,888.80
Ebit	9,152.90	9,683.20	10,237.10
Pre-tax profit	8,006.80	8,506.70	9,007.00
Post-tax profit	6,001.80	6,391.30	6,755.30
EPS (¢)	785.2	860.1	929
Dividend (¢)	478.7	499.2	532.5
Capex	2,301.60	2,089.10	1,761.80
Free cash flow	5,975.60	6,466.20	7,084.00
Net borrowing	33,000.80	34,652.20	37,203.20

Source: SharePad

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