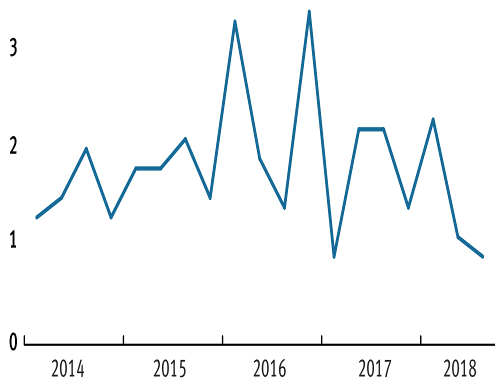
investors CHRONICLE alpha

28 March 2019

Phil Oakley's Weekly Round-Up

There are worries for the global economy right now, which are being reflected in a rough patch for markets. Although, there could be opportunities for stockpickers who can stay the course

German GDP growth rate (%)



Source: Bloomberg

Alpha Production Editor: Sameera Hai Baig

The companies mentioned this week are:

- Fevertree Drinks
- Bellway
- DP Poland
- AG Barr
- Michelmersh Brick Holdings

Fantasy Sipp

Funds % returns	1 month	Year-to-date	1 year
Fundsmith Equity T Acc	3.51	12.7	21.8
Lindsell Train Global Funds	3.68	9.39	22.3
Phil Oakley Fantasy Sipp	**2.6**	**8.9**	**16**
Vanguard S&P 500 ETF	0.876	8.28	15
Finsbury Growth & Income Trust	2.13	8.1	12.4
FTSE All-Share – Total Return	1.43	8.09	5.37
Scottish Mortgage Investment Trust	-0.77	4.94	12.2
Castlefield CFP SDL UK Buffettology Fund	-0.0522	2.96	4.83

Source: SharePad

The markets are going through a bit of a rough patch. The worry now is that the world economy is slowing down and some countries may go into recession and see their economies shrink in size. This would be bad news for company profits and may cause share prices to fall a lot.

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I don't think this pessimistic view of markets is too unreasonable. Germany is perilously close to a recession while key lead indicators of economic activity such as housing and car production are weak. We are 10 years into an economic expansion and are probably due some kind of slowdown which has always been part and parcel of our economic system. That just leaves the debate on how big the slowdown will be.

I've no idea and have learned not to worry about these kinds of things because I can't do anything to change them. What will be, will be.

You might think that such thinking is somewhat complacent. It isn't. I just believe that if you are going to be a long-term investor in shares you must accept that there is a good chance there will be some ups and downs from time to time. The key is to invest in good companies that have shown that they have been resilient to economic downturns in the past. This is what I have done with the Fantasy Sipp portfolio.

It would not surprise me at all if there was a significant sell off in the stock market. However, if this kind of event scares you and you want to run for cover and try and time the market then my guess is that you will be too scared to get back in - you will always think that worse is to come. If you think like this, then perhaps investing in shares is not for you.

I am a firm believer in long-term buy and hold investing. The trouble is that this is easy to say when the markets have been going up. The real test of a buy-and-hold strategy comes when the markets are falling. Many people can't stand by and see the values of their investments plummeting. This is perfectly understandable.

So where are we now?

Your guess is as good as mine. I think it's likely that central banks will start cutting interest rates again – if there's anything left to cut – and perhaps print more money if economies weaken.

But will this bail out the stock market again?

Maybe not. Low interest rates over the past decade have been great for stock markets because profits in general have been moving up. If profits start to fall then I can't see that repeating.

What I can see happening is that shrewd stock picking may outperform passive strategies and boost long-term returns if investors can stay the course.

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Fevertree Drinks (LSE:FEVR)

Fevertree delivered another good set of financial results this week. Sales were up by 40 per cent with operating margins down slightly from 33.1 per cent to 31.7 per cent due to the impact of the sugar tax. The cost of the sugar tax was passed on in selling prices which boosted sales, but had zero impact on profit and so margins came down. They are still very impressive.

The key issue for this business remains unchanged: It needs to demonstrate that its products have significant broad appeal beyond the UK and beyond mixing with gin. To justify its very high stock market valuation – 48.2 times forecast earnings at 2,875p – it needs to crack the US market. My view, for what it's worth, is that this is going to be difficult.

Fevertree has laid the foundations to try and create a big business in the US by signing an exclusive on-trade – bars, restaurants, hotels and cafes – distribution agreement with Southern Glazer Wine and Spirits in 29 states. It has complemented this with agreements with regional distributors in other states. All it has to do now is convince Americans to drink more of its mixers.

This is easier said than done. Fevertree has benefited enormously from the popularity of gin and tonic as a drink in the UK. It doesn't have that going for it in the US.

Americans are big bourbon whiskey, scotch, rum and tequila drinkers. They also drink a lot of vodka shots and complicated cocktails. I am not sure that these consumer habits lend themselves to Fevertree doing really well.

Will a US customer mix his Bourbon with Fevertree cola rather than Coca-Cola or Pepsi? I'd be very surprised if that happened.

The other thing often talked about is the growth of premium spirits. As far as premium gin is concerned, I think Fevertree is in a great position. For premium bourbon or scotch this is not the case. People buying expensive, premium whisky are more likely to drink it neat or with water or ice. They are not going to ruin the experience by mixing it with anything else.

The US remains a very small market for Fevertree with just £35.8m of sales last year which grew by 21 per cent compared with 53 per cent in the UK. The US business needs to show a big increase – on a small revenue base – in my opinion. I'd be more confident in further growth coming from the on-trade in the UK.

One very welcome development has been the reduction in trade debtors as a percentage of sales from 32.7 per cent to 26.5 per cent. I had been concerned that Fevertree was getting too dependent on big offers of trade credit near the end of its reporting periods in order to post strong sales growth. I now feel more relaxed on this and feel that given its asset light business model, trade credit is a legitimate investment in a business looking to grow - as long as the quality of customers is not degraded as a result.

Fevertree is doing very well right now. It needs to broaden its sales base. There is also a risk that the gin boom in the UK will not last and that the mixer begins to dominate the spirit in the drinking experience.

The shares continue to price in a very prosperous future and contain no room for disappointment.

Fevertree cash flow

	2018 £'000	2017 £'000
Operating activities		
Profit before tax	75,577.4	56,426.8
Finance expense	107.0	71.9
Finance income	(327.2)	(94.9)
Depreciation of property, plant and equipment	738.6	405.4
Amortisation of intangible assets	720.0	720.0
Share based payments	1,821.8	1,135.9
	78,637.6	58,665.1
(Increase) in trade and other receivables	(7,301.0)	(26,405.2)
(Increase) in inventories	(16,414.0)	(2,712.0)
Increase in trade and other payables	3,461.9	13,820.5
	(20,253.1)	(15,296.7)
Cash generated from operations	58,384.5	43,368.4

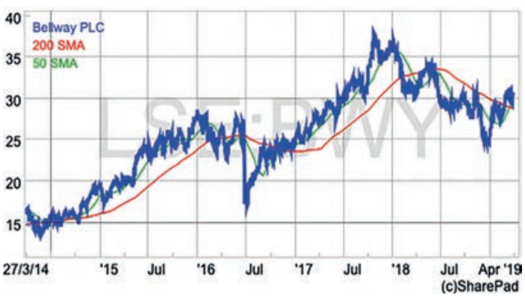
Source: SharePad

Fevertree Drinks PLC (FEVR)

FORECASTS £ millions unless stated

Year	2018		2019		2020	
Turnover	236.2	+38.8%	278.4	+17.9%	330.9	+18.8%
EBITDA	77.2	+31.6%	88.3	+14.4%	103.9	+17.6%
EBIT	74.9	+32.6%	85.8	+14.5%	100.7	+17.4%
Pre-tax profit	75.1	+33.1%	86.0	+14.5%	100.0	+16.4%
Post-tax profit	60.7	+31.5%	69.3	+14.2%	81.9	+18.1%
EPS (p)	52.2	+30.5%	59.6	+14.2%	70.3	+18.0%
Dividend (p)	13.7	+28.6%	16.1	+17.5%	19.9	+23.6%
CAPEX	1.3	+7.5%	1.4	+2.8%	2.0	+48.7%
Free cash flow	45.8	+39.8%	60.1	+31.2%	69.4	+15.6%
Net borrowing	-83.3		-125.9		-177.5	

Source: SharePad



Bellway (LSE:BWY)

Results from house builders have been following a very similar pattern in recent weeks. Modest growth in the number of homes sold and a continued growth in average selling prices is being offset a little by rising building costs and leading to steady increases in operating profit.

Bellway's half-year results confirmed this trend this week with operating profits increasing by 8.7 per cent to £319.8m. The results were helped by sales from the Nine Elms development in London which saw private average selling prices in the south of England increase by 12 per cent. In the north, private average selling prices increased by just 1.9 per cent.

Help-to-Buy (HTB) and the increase in selling prices relative to the second-hand market it has delivered continues to help out builders such as Bellway. However, that effect is beginning to wear off.

It seems that profit margins for Bellway – and the sector in general – may have peaked in this current cycle. Build cost inflation is currently running at around 3 per cent and house price inflation is slowing down. Bellway is expecting margins to keep on trending down and settle at around 20 per cent.

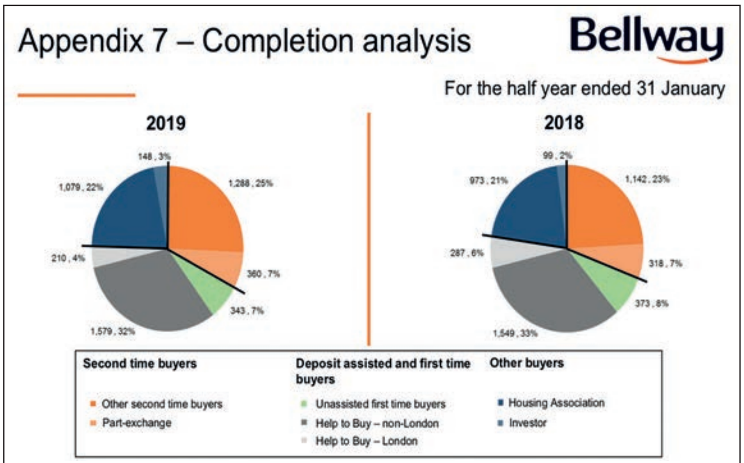
Bellway PLC (BWY)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	3,104.5	+5.0%	3,220.4	+3.7%	3,420.3	+6.2%
EBITDA	676.6	+3.0%	686.4	+1.4%	720.3	+4.9%
EBIT	675.4	+3.1%	686.5	+1.6%	717.7	+4.6%
Pre-tax profit	664.3	+3.6%	678.9	+2.2%	708.5	+4.4%
Post-tax profit	538.4	+3.6%	553.2	+2.8%	575.4	+4.0%
EPS (p)	436.9	+3.6%	449.3	+2.8%	470.0	+4.6%
Dividend (p)	147.1	+2.9%	159.3	+8.3%	169.8	+6.6%
CAPEX	3.6	-8.7%	3.7	+3.7%	4.0	+7.9%
Free cash flow	288.9	+15.4%	379.5	+31.4%	364.7	-3.9%
Net borrowing	-201.7		-374.4		-594.1	
NAV	2,920.0	+14.2%	3,308.0	+13.3%	3,717.0	+12.4%

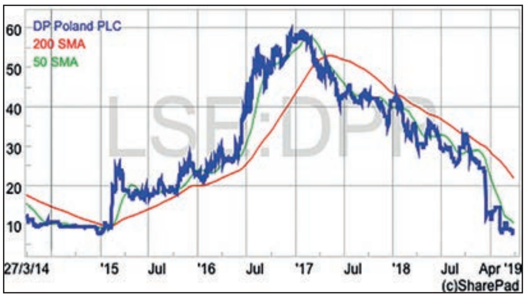
Source: SharePad

What this means in practice is that Bellway is going to have to sell more homes in the years ahead to keep its profits growing. This may happen, but it looks as if this is going to be quite difficult to do.



Source: Company presentation

HTB has two more years left in its current form before becoming available to first-time buyers only between 2021 and 2023. At the moment, 36 per cent of Bellway's home sales come from HTB but only 5 per cent of sales are over the Help-to-Buy price threshold of £600,000. Just under two thirds of sales are at a price point of less than £300,000 and remain well supported by the scheme.



But what happens when HTB ends?

I can see a significant reduction in the new build premium currently being achieved by builders. This would likely lead to falling profit margins on plots in the existing land bank.

Therefore, I understand why analysts' current forecasts for profits growth is very modest.

That said, as long as selling prices and volumes hold up and margins and return on capital employed (ROCE) of around 20 per cent can be achieved, then I don't see Bellway shares as being poor value right now – they are on a one year rolling forecast price/earnings ratio (PE) of 6.7 times and a P/NAV of 1.4 times – but I do see them as risky.

DP Poland (LSE:DPP)

DP Poland has the master franchise to use and operate the Domino's Pizza brand in Poland. On a standalone basis, selling pizzas is very profitable with good gross profit margins. If you sell enough of them and can cover the overheads of running shops, the profits can very reasonable as has been seen with DP franchisees in the UK.

As far as DP Poland is concerned, things aren't going very well. While system sales were up by 24 per cent, the earnings before interest, taxes, depreciation, and amortisation (Ebitda) loss increased from £1.78m to £1.92m. This company looks to be in a bit of mess.

It currently has 42 corporate stores and 24 franchises supported by two distribution centres. Some of the corporate stores are struggling and have been closed or have had their balance sheet values impaired (reduced) to reflect their weaker future prospects. Some franchised stores are also struggling, with the company mentioning the risk for bad debts coming from them.

Competition in Poland is fierce and has hurt DP Poland over the past year. The business is already in the process of splitting delivery areas – something which is not going down well in the UK – and this is cannibalising sales. Like-for-like system sales growth declined from 6 per cent to 4 per cent when splits were taken into account.

DP Poland PLC (DPP)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	13.0	+25.1%	12.7	-2.6%	16.3	+28.5%
EBITDA	-2.1		-2.0		-1.4	
EBIT	-3.1		-3.2		-2.8	
Pre-tax profit	-3.1		-3.2		-2.6	
Post-tax profit	-3.1		-3.2		-2.8	
EPS (p)	-2.1		-1.8		-1.4	
Dividend (p)	-		-		-	
CAPEX	1.8	-58.2%	1.5	-14.3%	1.5	0.0%
Free cash flow	-		-		-	
Net borrowing	-1.1		-3.6		-0.3	

Source: SharePad

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I am struggling to see how this company is going to turn a profit any time soon. It needs much bigger sales uplifts and the benefits of maturing stores to leverage the fixed overheads of the business.

In short, I don't see why investors need to own the shares. As Domino's Pizza UK is finding out making good profits in Europe is hard to do and it has yet to do so.

AG Barr (LSE:BAG)

I've always liked AG Barr as a business. It is underpinned by the strength of its Irn Bru brand in Scotland and has successfully complemented this with some smart acquisitions and licenced brands. The business makes good profit margins and generates decent amounts of free cash flow. As a share to tuck away and forget about, there's a lot to like.

My only concern about this business in recent years has been its ability to grow. An aborted merger with Britvic a few years ago was a shame as I think this combination could have been a great success.

Profits growth in 2018 was just 2.5 per cent at the pre-tax level. Revenue growth of 5.6 per cent was reasonable but higher operating costs during the hot summer, and higher marketing spend, held back profits and saw margins fall back slightly.

From a competitive positioning point of view, the company has performed well. Irn Bru has gained further market share in England whilst Funkin cocktails flavour and Barr carbonated flavoured drinks have done well. The Rubicon juice drinks business has seen decent volume growth despite a decline in the number of consumers buying juice drinks in the UK.

It seems that this performance has come from a slight temporary tweaking of the company's usual strategy. To get around the uncertainty of the effect the sugar tax might have had on its business, it has pursued a promotional and volume approach during the last year or so.

Barr (AG) PLC (BAG)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	284.2	+2.3%	288.7	+1.6%	297.6	+3.1%
EBITDA	55.0	+3.2%	56.5	+2.8%	58.2	+2.9%
EBIT	46.1	+5.3%	47.7	+3.5%	49.4	+3.6%
Pre-tax profit	45.5	+4.4%	46.8	+2.9%	48.4	+3.3%
Post-tax profit	36.9	+2.1%	38.1	+3.3%	39.3	+3.3%
EPS (p)	32.2	+2.9%	33.8	+5.0%	34.8	+3.0%
Dividend (p)	16.1	+3.5%	17.2	+6.8%	17.7	+2.9%
CAPEX	11.0	+1.9%	17.7	+60.6%	14.0	-20.8%
Free cash flow	32.2	+2.9%	26.6	-17.2%	34.0	+27.4%
Net borrowing	-14.5		-18.5		-33.6	

Source: SharePad

Going forward, it is going to revert to a focus on sales value rather than sales volume which I think makes sense. This is a strategy that has worked very well with its rival Nichols, which has refused to discount its Vimto brand without any adverse effects. This should help margins rebuild a little which would be positive.

Forecasts for the year to January 2020 look quite modest to me. Given the change in strategy and a better cost performance, I think there is scope for forecasts to nudge up a bit. The company remains in a very strong financial position with net cash on the balance sheet. Unless it spends this on acquisitions, I think there is scope for more share buybacks or a special dividend.

That said, despite its undoubted qualities, its weak growth outlook leads me to think that its shares are a little expensive at the current share price of 790p, which equates to a forecast rolling PE of 23.5 times.

Michelmersh Brick Holdings (LSE:MBH)

I very much like the look of UK brick makers at the moment. The demand for their products is buoyant and exceeds supply while industry stock levels are low. This should put them in a good position to grow their profits over the next few years.

Michelmersh, the smallest of the listed brick makers behind Forterra and Ibstock had a very good 2018. Strong demand and the benefit of a full year contribution from an acquisition last year saw sales grow by 22 per cent and operating profits by 45 per cent.

The business is making operating margins of 15.2 per cent, free cash flow margins of 15.6 per cent but ROCE remains rather underwhelming at 7.9 per cent.

Despite this, I think this business is in a very good place right now. It has a well balanced business spread across new builds, repairs and maintenance, social housing and regeneration markets. It has also just bought a small business in Belgium which gives it a foothold in Europe as well as another way to supply UK markets.

Michelmersh Brick Holdings PLC (MBH)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	44.5	+17.5%	46.9	+5.3%	51.7	+10.4%
EBITDA	11.1	+39.4%	11.9	+7.7%	12.8	+7.1%
EBIT	9.1	+81.0%	9.2	+1.7%	9.7	+5.4%
Pre-tax profit	8.5	+82.0%	8.8	+3.5%	9.2	+4.5%
Post-tax profit	6.8	+121.4%	7.0	+2.9%	7.3	+3.5%
EPS (p)	7.9	+33.9%	7.8	-1.3%	7.9	+1.3%
Dividend (p)	3.2	+48.8%	3.3	+3.1%	3.5	+6.1%
CAPEX	2.7	+169.5%	2.8	+1.9%	2.5	-9.1%
Free cash flow	6.8	+78.4%	6.0	-11.1%	7.7	+28.3%
Net borrowing	13.1	-25.0%	11.7	-10.7%	9.0	-23.1%

Source: SharePad

It also has a very strong asset base with clay reserves of more than 20 years' production at current levels. I'd still prefer to own Forterra but this is not a bad business at a reasonable valuation of 11.6 times rolling forecast EPS.

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