



Phil Oakley's Weekly Round-Up

After a few weeks of wild speculation, reality might just be beginning to catch up with stock markets

Fantasy Sipp & UK Quality shares performance

	1 month	Portfolio total returns (%)		
		Year to date	1 year	2 years
Scottish Mortgage Investment Trust	14.8	20.1	38.3	38.0
LF Blue Whale Growth Fund	11.9	6.3	16.3	35.6
Smithson Investment Trust	11.5	5.2	17.3	
Fundsmith Equity T Acc	8.0	1.9	11.3	28.4
Lindsell Train Global Funds	6.0	-1.9	1.6	21.3
Mid Wynd International Inv Trust	3.7	-2.3	11.9	18.3
Martin Currie Global Portfolio Trust	3.4	-2.5	9.9	22.6
Vanguard S&P 500 ETF	4.5	-3.6	9.9	20.7
Phil Oakley Fantasy Sipp	4.0	-3.9	9.7	27.1
Finsbury Growth & Income Trust	2.6	-10.2	-5.8	5.1
Phil Oakley UK Quality Shares	3.0	-14.4	-	-
Castlefield CFP SDL UK Buffettology	6.0	-16.3	-8.4	2.9
Vanguard FTSE 100 ETF	2.1	-20.3	-12.8	-15.3
FTSE All-Share – Total Return	1.3	-21.3	-13.7	-16.8
Vanguard FTSE 250 UCITS ETF	-2.1	-27.3	-14.4	-18.7

Source: SharePad

Reality starting to bite

After a few weeks of wild speculation, it seems that reality might just be beginning to catch up with stock markets.

We are arguably experiencing the worst economic conditions in living memory. We have seen a huge and rapid loss of jobs in America and massive amounts of money being borrowed and spent in the UK to stop the same thing happening.

The point is that people without jobs have less money in their pockets to buy the stuff that most companies listed on the stock exchange provide. It's hard to see how this is conducive to companies growing their profits and for share prices – which looked very fully valued before the coronavirus hit – to be going up. The “there is no alternative argument” looks to be getting weaker to me.

The reliance on the Federal Reserve to bail out Wall Street and by association other stock markets around the world, just shows how addicted to cheap money they have become.

Alpha Production Editor: Sameera Hai Baig

Printing money to buy bonds may stop interest rates on government debt from going through the roof for a while, but it does not put money into many household bank accounts. Also, it will not encourage people to borrow and spend because those that have been doing this have already maxed out their borrowing capacity or have no income to take on any more debt.

On most measures, the valuations of good businesses are very expensive and look unsustainable as their profits fall throughout the year.

Sadly, I feel that the hope for a “V”-shaped recovery is a case of very wishful thinking. Unless we get a vaccine for coronavirus quickly, social distancing measures are going to continue. This means that the business models of many consumer-facing businesses are in big trouble, as they are not going to be able to serve enough customers to make any meaningful profits. This will then feed into weak demand into their supply chains and won’t trigger the recovery that people hope for.

Everyone seems to have an opinion on coronavirus, so here’s my two-penneth worth: I think a second wave is a near certainty and this is all part of the UK government’s current thinking. When people are locked down in their homes it’s more difficult to contract the virus, but the virus has not disappeared and so when they start going out again the number of infections increase. This is what we are seeing in places such as Germany and South Korea.

Without a vaccine, the only way we are likely to get out of this situation is for herd immunity to be established – if it can be. This means that more people need to get infected. I think this is the government’s plan and it has been waiting for enough capacity to become available in the NHS to cope with a second spike before easing some of the lockdown measures. When the government says forget about going on holiday in July and August, I can’t help thinking that this is when it expects another wave of the virus to spike and another lockdown to be in place.

The economy may have to take another hit and it looks very vulnerable.

In my opinion, people are right to speculate about falling prices or deflation given the hit to economic activity and what might come. But food price inflation is on the up and it is possible that we could have falling general prices, but rising food prices, which is a nasty mix.

My real worry is that the UK economy looks to be in a very bad place to cope with this. As I type, £1 buys \$1.219 and €1.131, and it could go lower. The UK government is going to have to borrow around £300bn this year and I’m not sure that investors will oblige it.

This has led many financial commentators to say that it doesn't matter because the UK government can print its own money to fund the borrowing. To say this is to ignore the fact that there is no free lunch, as this will continue the process of destroying the buying power of paper money.

The fact that many governments are trying to do this is largely irrelevant in the long run as once started, history tells us it's difficult to stop. Even though deflation may be the driving force in the short run, this will reduce government's tax receipts and push up its borrowing requirement, which may lead to more printed money. Sooner or later you end up with too much money chasing too few goods and services, and prices take off.

I fear that as far as the value of the pound sterling is concerned the markets are working this out for themselves.

This is a horrible situation to be facing up to. I expect economic activity to resume, but I think many ways of doing things will change and that getting back to where we were is going to be hard. I worry that the UK's reliance on debt-based consumer spending supported by inflated property prices and low levels of investment in real productive capacity will come back to bite it hard.

What is a UK investor to do?

This is a really hard question to answer and I don't think I can add much here. But I think having exposure to overseas assets or companies with overseas earnings is a sensible strategy, as I think the value of the pound still has considerable downside risk.

A diversified portfolio of investments is key at times like this, despite the absence of safe income-producing assets. None of us know what is going to happen, but covering all scenarios in some way makes sense to me.

As far as shares are concerned, the problem remains that safety is very expensive in terms of the valuations investors are having to pay for robust and resilient businesses. But if you own shares in any of them, hanging on to all or at least some of them is probably sensible. Having a decent slug of cash also still seems to make a lot of sense.

What is infuriating about all of this is that we are where we are not because of coronavirus and the response to it – that was just the catalyst – but because capitalism has failed. By stopping failure and loss, the central banks of the world have prevented markets from clearing properly and finding lower prices that stimulate a revival in economic activity.

By keeping interest rates below inflation – and even eliminating them altogether – they have destroyed the

incentive to save and have inflated asset bubble after asset bubble without improving the productive capacity of economies that ultimately make people better off. The more they meddle, the worse mess they make.

I'd like to be more optimistic right now, but I think the risks are too high for the rewards that seem to be on offer. Recessions and bear markets are a natural part of capitalism and are good for its long-term prosperity, despite the pain they inflict at the time. We need to let the system work, but I am not naive enough to think that this is going to happen any time soon.

All this said, we will get through this and opportunities for investors will present themselves as they always do. Hanging on to what you have should take precedence right now.

Sage

Sage (SGE) is a business I have had my doubts about. It is an extremely profitable business with good products and good customer loyalty, but I have felt it was losing out in the growth stakes to more aggressive companies such as Intuit and Xero. I still do.

Elsewhere, the strategy of moving away from selling software licences to subscriptions and becoming a software as a service (SaaS) company is a good one and should be good for stability of revenues and ultimately profits and profit margins.

Despite my concerns about its competitive positioning, I think this week's half-year results from the company were quite reassuring. Total revenues increased by 3 per cent with organic recurring revenue growth of 10.3 per cent, so that it now makes up 88 per cent of total revenue.

Software subscription revenue increased by 25.6 per cent, taking it to 62 per cent of total revenue, with 56 per cent of total revenues now on the Sage Cloud. This was offset by a continued decline in the sales of software licences and professional services.

The company's performance in North America and Northern Europe was encouraging with revenue growth of 4 per cent and 9 per cent respectively. In the US, the Sage Intacct financial and business management product again saw very strong rates of growth.

Operating profit was only up marginally to £218m with profit margins down slightly to 22.4 per cent from 22.9 per cent, as the company spent more money getting customers to switch to subscriptions, but there was also a £13m hit from bad debts related to Covid-19. This bad debt is quite a big number for just a couple of weeks in the half-year to March and needs to be watched as my

concern would be that the damage being done to the UK economy from the current lockdown could see a much bigger number in the second half of the year. All credit to Sage, though, for not treating this as an exceptional item as many companies would have done, in my opinion.

I think it's fair to assume that the second half of the year is going to see a much bigger negative impact on profits from Covid-19. In April, the company said that new customer acquisitions were running at around half their normal levels, while existing customer churn rates have been slightly higher.

The company continued to generate plenty of free cash flow, which is £399m on a trailing 12-month (TTM) basis or 36.3p per share. This, and the resilience of its business, has seen the half-year dividend increase by 2.5 per cent to 5.93p per share.

Recurring revenue growth will be slower in the second half of the year and there's a good chance that bad debts will go up as well. While the company has not given any formal profit guidance, my view is that profits will be a little bit lower than 2019, but not by that much.

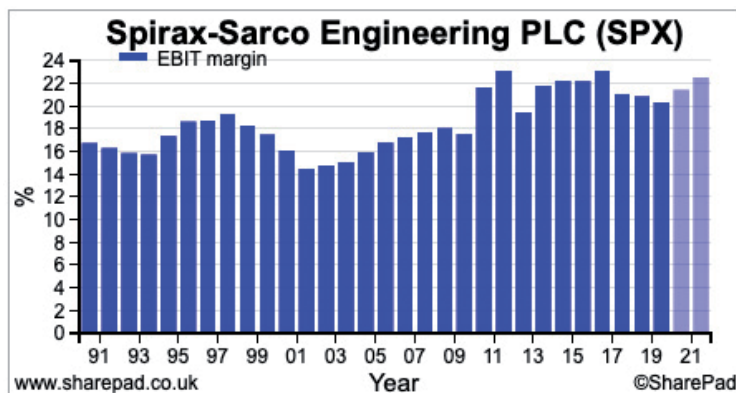
I think Sage shareholders should be reasonably happy with where the company is right now, as its strategy of becoming a very profitable SaaS company is going well with more scope to improve the quality of revenues. Growth remains an issue, but there are more important things to deal with right now.

Sage is a high quality business in a UK stock market which doesn't have too many of them. At 679p at the time of writing, its shares trade on a TTM free cash flow yield of 5.3 per cent – but slightly less than that on likely lower free cash flow for the year as a whole – which looks reasonable to me. I am happy to keep Sage in both the fantasy portfolios.

Spirax-Sarco

I've said before that I think **Spirax-Sarco (SPX)** is one of the best businesses listed on the UK stock exchange. There's so much to like about it from its problem-solving products, the way it integrates itself with its customers, its resilient revenue streams and its high and consistent levels of profitability.

Despite having businesses that tend to move in tandem with trends in global industrial production, the company has always weathered recessions well with a stability of high operating margins that few companies can match.



But it is not completely recession-proof as this week's trading statement confirmed. The company is now basing its outlook for the year on a forecast decline in global industrial production of 6.6 per cent.

One of the key strengths of this company is that 85 per cent of its revenues are related to maintenance and repairs, which is part of its customers' day-to-day running costs and is therefore much less likely to be put off than a big capital project. Spirax has only seen a mild decline in revenues from this source.

It has also benefited from having around half of its sales going into critical sectors dealing with essential sectors that need to keep working, despite the lockdowns across the world, such as hospitals, pharmaceuticals, food, power generation and water.

Yet, it's fair to say that not everything in the garden is rosy right now. Inevitably some of its customers have had to cut back as they are selling less. This means that Spirax-Sarco's organic revenues for the first four months of 2020 were down by 5 per cent, with April seeing a fall of 8 per cent. The next six months are likely to see bigger falls than this. The company hopes that the last quarter of the year will see some recovery as long as there is not a disruptive second phase of coronavirus.

Performance by division

Division	Organic revenue growth
Steam Specialities	-7%
Electric Thermal Solutions	-9%
Watson-Marlow	+4%

Source: Spirax-Sarco

The Electrical Thermal Solutions business has been hit by the Chromalox subsidiary being exposed to oil and gas projects in the US which are having a particularly tough time right now, but the contribution from the Thermocoax business acquired last year will offset some of the profit hit.

The Watson Marlow pumps business is doing quite well, as it has significant exposure to the biopharmaceutical and medical device market where customers are producing testing kits and trying to develop vaccines for Covid-19.

The company is keeping a tight rein on costs, but operating profit for the first four months of 2020 is lower than for the corresponding period in 2019. What's encouraging is that operating margins are still above 21 per cent.

2020 is going to be very tough, but one of the key attractions of the business – its resilience – is again shining through. Many engineering companies with businesses tied to the industrial production cycle tend to have very high operational gearing in a downturn – their profits tend to fall much faster than their revenues. Spirax cannot totally escape this effect as it does have fixed costs, but it has said that it has tried to limit the damage from operational gearing:

“As a result of cost containment and efficiency improvement initiatives that have been put in place, we currently anticipate that the full-year drop through of total revenue decline to operating profit in 2020 will be contained to around 45 per cent.”

What this means in practice is that if revenues fell by £10m, profits would fall by £4.5m. That's still quite a big hit and would see profit margins come down a bit, but hopefully its income statement will not be decimated.

Spirax remains an excellent business with decent long-term prospects when things get back to normal. Its shares are a scarce asset in a UK stock market with a dearth of quality companies. This is reflected in the screamingly expensive valuation attached to them. At 9,311p, the shares trade on a TTM of 36 times and offer a free cash flow yield of just 2.4 per cent.

These shares have done very well for my Fantasy Sipp. I started buying them in late 2017 and have an average cost price of 5,648p, which equated to a PE of 23.5 times back then. I wouldn't be buying them today, but I wouldn't sell them either.

Morrisons

I've always had a bit of a soft spot for **Morrisons (MRW)**. It's due in part to my Yorkshire roots and the fact that I was briefly a food retail analyst during my time in the City and the company I worked for was the house broker.

It was when Ken Morrison was still running the company and I got to know it quite well. It was an excellent business back in the early 2000s before it went and bought Safeway. Return on capital was over 20 per

cent, it generated shedloads of cash and had some of the most prudent accounting I've ever come across. It used to depreciate freehold land and had proper depreciation for its fixtures and fittings which, in my view, Sainsbury's and Tesco did not. In other words, you could believe its profits were real.

A lot has changed since then, but the current management team seems to be doing a reasonable job in difficult circumstances.

Morrisons' sales have benefited from the panic buying by consumers in early March, with like-for-like sales increasing by 5.7 per cent for the first 14 weeks of its 2020-21 financial year. But this is not going to help its profits, as its costs have gone up a lot to adapt to the demands of shopping with coronavirus.

As far as the outlook for the year is concerned, profits should hold up quite well, as the extra costs will be offset by the savings from not having to pay business rates. It is losing some profit from the current closure of its in store cafes and lower fuel sales.

Looking further out, there are some positive developments for the business, which should start coming in over the next few months.

Its wholesale business should get a nice boost when it starts supplying over 240 McColl's convenience stores, which have yet to take Morrisons' products.

Morrisons is also stepping up its involvement with Amazon, with the Morrisons store on Amazon Prime going nationwide. I've often wondered whether Amazon might eventually buy Morrisons if it thinks that food retail is a business it can succeed in, but it might just be that the current arrangement suits both parties just fine at the moment.

Morrisons has also doubled its weekly delivery slots for its Morrisons.com business and will keep on adding more, as well as offering more click-and-collect slots. The company still lags behind its larger peers in online grocery and has a bit of a confused strategy working with both Ocado and Amazon. As with all the big supermarkets, it has yet to prove whether selling groceries over the internet makes meaningful profits or is just an expensive way of defending market share.

I am still concerned that Morrisons remains very vulnerable to losing customers to Aldi and Lidl in its northern heartlands, and recent market share data suggest that this is still happening.

That said, losses are small and the company seems to be working well with the sales that it has. Free cash generation remains excellent and supports the 3.5 per

cent trailing dividend yield on the shares. I expect special dividends to return when the economy settles down a bit.

It's not a share that's going to make you very rich, in my opinion, but it arguably has one of the safest dividends with a half reasonable yield on the UK market and further special payouts to boost it. A takeover by Amazon cannot be ruled out, but should not be seen as a reason to buy the shares, in my view.

Treatt

Treatt (TET) is a business that I quite like. It produces flavours and fragrances that are used in consumer products such as soaps, beauty products, sugar-free beverages and teas that are supported by favourable retail trends.

The only reason I quite like it rather than really like it is because I believe it will struggle to make high returns on its investments for a while. I believe that Treatt's profits, return on capital employed (ROCE) and cash flows have been flattered up until quite recently, by a high capacity utilisation on its existing asset base, and that the expensive cost of adding new capacity will drag down returns for a good few years into the future.

This is highlighted by the fact that the capital invested in the business has doubled since 2017, but operating profit has barely budged. A business that used to have a ROCE of nearly 20 per cent in 2017 now has one of just over 10 per cent, according to my calculations.

To be fair to Treatt, its new natural extracts capacity in the US will take some time to get up to high levels of utilisation, which will hopefully boost returns, but the new UK facility currently being built will drag down returns again and subdue free cash flow generation.

Don't get me wrong, it is heartening to see a business with good products and good prospects investing in new assets, but from an investment perspective you always have to ask whether the returns on those assets will be attractive. Hopefully, in time they will be, but I'm not sure Treatt will get back to being a 20 per cent ROCE business any time soon. I will be happy to be proven wrong.

The other thing that I find slightly off-putting is the continued dominance of its citrus business, which accounts for half its revenues. Revenues and profits are strongly linked to movements in raw material prices – I presume that there is some pass through clause in customer contracts – which means profits go up when prices rise and down when they fall. They have been falling recently, but prices are expected to go up again in the second half of 2020.

Half-year results to March 2020 were released this week

and were reasonable. Revenues were down by 5.3 per cent to £53.6m, with operating profits down by 3.9 per cent to £6.1m. This was largely due to the decline in citrus revenues. Citrus still dominates Treatt, but it has three innovative non-citrus businesses which currently account for 20 per cent of revenues that are growing very nicely.

Non-citrus revenues from fruit and vegetable products, tea flavours and sugar reduction products increased by 7.2 per cent and helped gross profit margins improve by 120 basis points.

Fruit and vegetable-based products that go into beverages account for 7 per cent of revenues and saw sales increase by 9.4 per cent.

Demand for premium beverages and the innovative ingredients that go in them is still very strong. Tea revenues increased by 47.5 per cent and the new tea extract capacity in the US is very favourable in this respect. Tea currently represents 6 per cent of Treatt's revenues and seems to have the potential to grow to become a bigger chunk of them over the next few years.

Treatt's health and wellness products account for 7 per cent of total revenues and are based around replicating the smell and taste of sugar without the calories. Revenues increased by nearly 20 per cent in the first half and the growth prospects here look to be good.

In both tea and wellness, Treatt is selling more to existing customers and winning new contracts and growing its market share in the process. It is looking at new products such as cold brew coffee to develop new revenue streams.

Profits for the full year to September 2020 are expected to be broadly in line with the board's expectations – whatever that might be – with current analysts' forecasts according to SharePad for EPS of 18.6p. TTM EPS to March was 17.6p. At 508p, the shares trade on a TTM PE of 28.9 times and a forecast PE of 27.3 times. Treatt is a nice business, but not a great one, in my view. The shares have performed well in 2020 and are up by 11.9 per cent year to date, but they look a little bit too expensive to me.

Renishaw

I wrote a detailed analysis on **Renishaw (RSW)** in the Investors Chronicle in early April. I like the intellectual property behind its metrology products, which are problem solvers and business improvers for its customers. The problem I have with it is that it has very limited visibility of revenues, with order books typically not much more than one month's supply.

The business is extremely profitable when times are good, but has very poor recession-resilience and profits can disappear very quickly, which seems to be happening right now.

Operating profits were £152m, with margins of 25 per cent in the year to June 2018. In the year to December 2019, they had fallen to just £62.8m.

This week's third-quarter trading update saw cumulative pre-tax profits (which are essentially the same as operating profits, as the company has no debt and therefore no interest payments) for the nine months to March fall from £79.6m a year ago to £31.8m. This gives TTM profits of £62.1m suggesting that profits have been relatively stable since December.

Trading activity

	9 months to 31 March 2020	9 months to 31 March 2019	Change
Metrology	£365.9m	£404.5m	-9.5%
Healthcare	£24.0m	£26.6m	-9.8%
Total Revenue	£389.9m	£431.1m	-9.6%
Adjusted* Profit before tax	£31.8m	£79.6m	-60.1%
Statutory Profit before tax	£19.7m	£84.8m	-76.8%

Source: Renishaw

The fourth quarter is shaping up badly. The company's guidance is for full-year revenues to be in the range of £490m to £505m, with adjusted pre-tax profits of £45-55m. This implies fourth-quarter profits of between £13m and £23m, compared with £30.3m last year.

Current consensus pre-tax profits for the year to June 2020 according to Factset are slightly below company guidance at £44.3m/47.3p earnings per share (EPS). Since the beginning of April, Renishaw's share price has increased from 3,000p to 3,755p, despite a worsening outlook for its profits. At its current share price, the shares trade on a forecast PE of 79.4 times. I know that cyclical companies are supposed to trade on high PE multiples at the bottom of the economic cycle when a strong recovery in profits is expected, but this valuation looks hard to justify to me.

Diploma

I don't usually like acquisitive companies, but **Diploma (DPLM)** is an exception to this. It is a good example of a business that has used acquisitions to complement its existing business, which have also been growing organically. This has turbo-charged profit growth over the years and has made its shares a very good long-term investment.

Like Spirax-Sarco, Diploma's customers are spending

their operating rather than capital budgets when buying its products, which gives them some recession-resilience.

The company has succeeded over the years by selling solutions to its customers rather than commoditised products and has been very good at building long-term relationships with them. Its decentralised business model has encouraged an entrepreneurial spirit that seems to have worked well.

Its diagnostic instruments and consumables, seals and controls are specialised, niche problem-solving products that can earn very high profit margins and attract low levels of competition. Even including all the money spent on acquisitions over the years, Diploma has a ROCE of nearly 23 per cent at the moment and nearly 36 per cent on its operating capital employed. With profit margins of nearly 18 per cent and free cash flow margins of nearly 12 per cent, it has the hallmarks of a very good business.

In normal times, its business can be relied upon to deliver low-single-digit percentage organic sales growth. These are not normal times and even before coronavirus hit, the business had virtually no underlying growth in revenues in the six months to March 2020. Operating profits increased by 9 per cent, due to acquisitions in its Seals business last year making an additional contribution.

Like so many other businesses right now, the second-half outlook is looking to be very tough. So tough it seems that the company has decided not to pay a half-year dividend when it has plenty of free cash flow to do so. That said, this is not the kind of share that will have been included in many income-seeking portfolios, but I find this rather strange nonetheless.

The current TTM operating profit and EPS is £101.5m and 66.3p, respectively. Consensus analysts' forecasts for the year to September 2020 (according to Factset) are for £94m and 58.1p, respectively. At 1,700p, this puts the shares on a forecast PE of 29.3 times, which is very rich, but symbolic of the kind of valuations scarce quality companies are commanding right now.

The shares are in my UK Quality shares portfolio and I'm happy to leave them there for now.

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