investors CHRONICLE alpha

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Phil Oakley's Weekly Round-Up

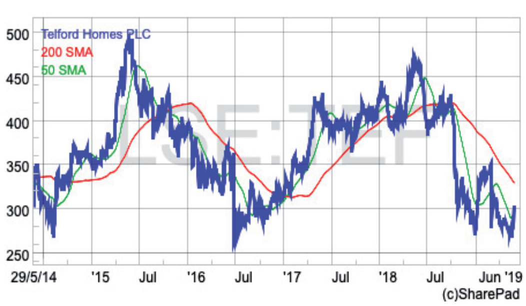
Regular discrepancies between a company's adjusted and reported profits are always worth closer inspection – and a closer look at the accounts of leading bus and rail operator FirstGroup shows why

The companies mentioned this week are:
- Telford Homes
- Galliford Try
- Fevertree Drinks
- Stobart
- FirstGroup

Fantasy Sipp performance

	Portfolio returns (%) 1 month	Year to date	1 year
Fundsmith Equity	1.91	20.1	18
Lindsell Train Global Funds plc	2.95	19.9	20.3
Phil Oakley Fantasy Sipp	**0.44**	**18.3**	**15.6**
Finsbury Growth & Income Trust	0.456	18.1	11.9
Castlefield CFP SDL UK Buffettology Fund	1.23	16.9	13.3
Vanguard S&P 500 ETF	-1.98	12.5	7.52
FTSE All-Share – Total Return	-2.82	9.18	-3.01
Scottish Mortgage Investment Trust	-4.47	7.61	-1.06

Source: SharePad



Telford Homes

Regular readers will know that I am not a fan of house-builders and I won't bore you again with the reasons why. **Telford Homes (TEF)** is an exception to this general view. I like the company's decision to focus on the Build to Rent sector in London.

The fundamentals of this market look good to me given how ridiculously unaffordable homes are in London to normal folk, even those with well-paid jobs. I also like the fact that this strategy takes a lot of risk away from the company's business model. It partners with long-term professional investors (such as M&G and Invesco) who buy the

Alpha Production Editor: Sameera Hai Baig

land and agree a price. Telford takes the construction risk, but still makes a much better margin – around 13 per cent – than most construction companies can dream of.

Two years ago, the company said that it hoped to make £50m of pre-tax profits in the year to March 2019. It actually made just over £40m as a couple of sites have experienced delays, which will see profits fall again in 2020 before hopefully picking up afterwards.

About 70 per cent of the company's pipeline is now in Build to Rent. The 30 per cent in individual sales is still making good profits (28 per cent gross margin last year), but this will come down a bit going forward as the benefits of building on cheaper land wear off. This market is difficult as selling prices get close to the £600,000 Help to Buy ceiling. Stretched affordability and a softer market has also seen increases in demands for discounts and incentives. This is not going to go away quickly, in my opinion, and vindicates the company's shift in strategy.

The move away from individual sales has reduced the capital requirement of the business and saw a big release of land and work in progress inventory last year, which led to a big improvement in cash flow and a reduction in gearing. I would expect this to stabilise going forward.

While the profit mix is changing towards lower-margin Build to Rent, the outlook for this business looks reasonable to me. It has a development pipeline of 4,900 homes, with a development value of £1.59bn, of which 60 per cent is forward-sold.

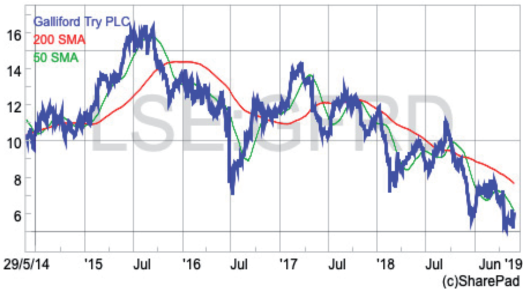
Telford Homes forecasts

	Year (£m)		
	2019	2020	2021
Turnover	356.1	371.7	458.7
Ebitda	47.1	31.8	37.7
Ebit	45.5	30.5	36.1
Pre-tax profit	40.1	24.8	30
Post-tax profit	31.9	20.2	24.6
EPS (p)	42.4	26.4	32.5
Dividend (p)	17	17	17
Capex	2	2	2
Net borrowing	118.4	120.4	113.8
NAV	251.4	258.6	270.6

Source: SharePad

Investors have gone lukewarm on Telford Homes, as its profit forecasts have come down. Some may point out that, at 290p, the shares trade at a discount to its net asset value (NAV) of 333p per share. That said, as the business model changes and the amount of land on the balance sheet comes down, NAV is perhaps less relevant as a valuation measure. Earnings may be a better yardstick.

The shares trade on a one-year forecast rolling PE of just over 11 times and offer a forecast dividend yield of 5.9 per cent. There's probably not much dividend growth in prospect for a few years, though, but the company has suggested that it might up its dividend payout ratio from one-third of profits. I like the business model, but I'm not convinced that the shares are compellingly cheap.



Galliford Try

In my weekly round-up on 19 April, I suggested that **Galliford Try's (GFRD)** depressed share price might flush out a bidder for its prized asset, Linden Homes. On Tuesday this week, Bovis Homes announced that it had tried to buy it, but had been rebuffed by Galliford's management who said that the offer undervalued the business.

Bovis offered £950m and would have taken on £100m of Galliford's private debt and paid for it entirely in Bovis shares. This doesn't look too shabby an offer given Galliford's market capitalisation of £597m last Friday night. Talks are no longer ongoing, but I think it's fairly reasonable to say that Linden Homes – but not Galliford Try – is in play now.

The trouble is that Linden Homes is the only thing worth owning in this company, as the construction part of it has proven to be something of a poison chalice.

Assuming the construction business is worth nothing and not a liability, I think Galliford Try shares are probably undervalued and that Bovis or another may come back for Linden Homes. A cash offer may get the deal through.

Galliford Try forecasts

		Year (£m)	
	2019	2020	2021
Turnover	2,762.80	2,754.30	2,797.00
Ebitda	189.9	194.6	207.1
Ebit	183.2	188.8	201.4
Pre-tax profit	175.8	176.6	193.9
Post-tax profit	143.9	137.4	151.4
EPS (p)	130.4	131.9	145.3
Dividend (p)	65.6	66.3	72.7
Capex	6	5.9	7.5
Free cash flow	15.9	103.3	103.3
Net borrowing	147	30.2	34.7

Source: SharePad

Fevertree Drinks

Fevertree Drinks (FEVR) has become a very good – almost great – business. In many respects, it is a triumph of marketing as it has convinced lots of people that its mixer drinks – especially tonic – with their natural ingredients are worth paying premium prices for.

Its problem is that most of its growth has come from the UK. To justify its current valuation – a one-year forecast rolling PE of 42.4 times at a share price of 2,721p – it has to demonstrate it can grow rapidly overseas, particularly in the US.

Last week's trading update fell a bit flat in giving evidence that it is doing so – a short, vague statement said it was on track to meet expectations. This is a share that needs forecasts upgrades and a new story for investors to pin their hopes on. The US story is not materialising and, if it is, it's not shifting forecasts up.

I remain deeply sceptical of Fevertree's ability to deliver sustainable growth from the US where the market is more dominated by dark spirits, where premium versions – unlike gin in the UK – don't tend to be mixed. I also don't see mainstream bourbons being mixed with anything other than Coca-Cola or Pepsi, if at all. The Americans' penchant for shots also does not lend itself to mixers.

The company also seems to be hedging its bets on its UK performance by referring to the boost it received from last year's hot summer, which was very helpful to it:

"While we are mindful of last year's exceptional summer trading performance in the UK, we remain confident in achieving board expectations for the full year ending 31 December 2019."

The other unknown is how long the UK gin boom will last. I've been around long enough to see booms in alcopops in the 1990s and cider in the noughties. Both were passing fads that saw sales boom only to fall back later on. It would not surprise me if gin followed suit.

Fevertree forecasts

	Year (£m)		
	2019	2020	2021
Turnover	282	330.6	383.5
Ebitda	89.3	103.7	119.3
Ebit	86.4	100	115.3
Pre-tax profit	85.9	99.9	114.3
Post-tax profit	69.9	81.4	94
EPS (p)	60	70.1	80.9
Dividend (p)	16.6	20.6	24.5
Capex	1.5	2	2.3
Free cash flow	59	69.5	81
Net borrowing	-124.9	-177	-235.1

Source: SharePad

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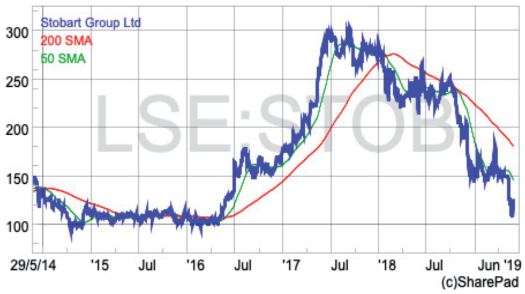


Fevertree shares have lost 15 per cent in the past month, and without upgrades I see the shares as expensive and not without forecast risk. I think the risk/reward trade-off is much better in a stock such as Britvic, which I reviewed in last week's round up.

Stobart

The only thing I really like about **Stobart Group (STOB)** is its ownership of Southend Airport. Having used it as a passenger for the past couple of years, I can say that the customer experience is good and far superior to the delays and general scrum experienced by many at nearby Stansted.

I think this is a very attractive asset for airlines and its customers, which should help it grow. Around 1.5m passengers used Southend last year, with 1m coming from easyJet. Ryanair started flights in April this year and Loganair has just begun operations. The year 2019-20 should be another good one in terms of passenger growth.

The problem for me is that I've got no idea how much this business is ultimately worth. My gut feeling is that the current market capitalisation of £460m has priced a lot of potential value into the share price.

The aim is to get to 5m passengers – providing the local residents can put up with lots of planes turning around at the bottom of their gardens – which will hopefully see it make some reasonable profits. The aviation business lost £1m last year, compared with a small profit of £0.6m.

Then there are the bits that I don't like too much.

The rail civil engineering business adds nothing and takes away a decent chunk of value having lost £7m last year. The energy business, which supplies biomass to energy recovery plants across the UK, remains the biggest source of profits and more than doubled its profits to £11.4m last year. The company says that the business is now operating at a run rate of 2m tonnes of deliveries a year and that it will start delivering a decent amount of operating cash flow.

It needs to, because Stobart's operating cash flow performance last year was awful with an outflow of £1.7m. I don't like the fact that the management talks about earnings before interest, tax, depreciation and amortization (Ebitda) all the time. Ebitda is a meaningless measure of profit in the kind of asset-intensive businesses that Stobart owns and where depreciation is a real cost. I'm always wary of companies that bang on about Ebitda.

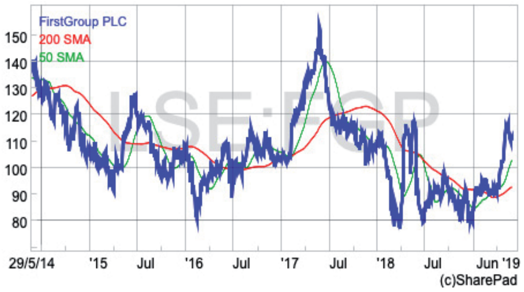
Stobart forecasts

	2019	Year (£m) 2020	2021
Turnover	266.8	323.1	363.5
Ebitda	25.4	37	49.8
Ebit	12.1	19.2	28.3
Pre-tax profit	9.2	16.3	25.7
Post-tax profit	8	15.2	24.2
EPS (p)	2.6	4.7	6.7
Dividend (p)	15	8.4	8.4
Capex	26.6	28.8	14.2
Free cash flow	-19.8	13.6	57
Net borrowing	94.4	95.5	87.6

Source: SharePad

I do like the fact that the company is cleaning itself up and simplifying itself. The sale of its remaining stake in Eddie Stobart Logistics for £53m after the year-end is a good move, but the company has been too reliant on selling things to generate cash inflows. It needs to get on and make its own businesses produce its own cash flows.

I think this is an interesting company to look at, but I just find it too difficult to work out what's really going on with it and find it hard to value. It goes in the too difficult pile for me. At 125p, the shares trade on a 2020 forecast PE of 26.6 times. This looks punchy, but if it can get rid of the losses in the rail business there is a big source of self help. That said, its messy accounts and poor cash flows mean it's hard to be really comfortable with its profits numbers without doing a lot more research.



FirstGroup

Last week in my magazine column, I wrote about the abuse of so-called normalised or adjusted profits. Of course, investors want to see the true underlying profits of a business so that they can form a reasonable view of it, but it seems that some companies will go to extraordinary lengths to keep bad things away from the sacred adjusted profits line. Bus and rail company **FirstGroup (FGP)** has been one of the worst offenders for a long time.

One of the quick checks you can do is to look at the difference between adjusted profits – the figure that management wants you to look at – and its statutory or reported profits, which take all income and costs into account. If there is a big difference between the two and this happens a lot then you need to have a closer look at what is going on.

This is how FirstGroup stacks up on this basis over the past few years. The differences between the two profit figures have been very big in the past couple of years.

First Group Operating profit (£m)	Reported	Adjusted	Difference £m)
2014	232.2	268	35.8
2015	245.8	303.6	57.8
2016	246.3	300.7	54.4
2017	283.6	339	55.4
2018	-196.2	317	513.2
2019	9.8	332.9	323.1

Source: Annual reports

If we look at the breakdown of the adjusted profits then it looks as if First Group's businesses had a better year in 2019-20.

	Year to 31 March 2019			Year to 31 March 2018		
	Revenue £m	**Operating profit[1] £m**	**Operating margin[1] %**	Revenue £m	Operating profit[1] £m	Operating margin[1] %
First Student	**1,845.9**	**173.5**	**9.4**	1,771.1	156.5	8.8
First Transit	**1,075.8**	**51.5**	**4.8**	1,072.7	58.2	5.4
Greyhound	**645.1**	**11.4**	**1.8**	690.2	25.5	3.7
First Bus	**876.1**	**65.8**	**7.5**	879.4	50.2	5.7
Group items[2]	**17.3**	**(41.6)**		16.2	(31.2)	
Road divisions	**4,460.2**	**260.6**	**5.8**	4,429.6	259.2	5.9
First Rail	**2,666.7**	**72.3**	**2.7**	1,968.8	57.8	2.9
Total Group	**7,126.9**	**332.9**	**4.7**	6,398.4	317.0	5.0

Source: Annual report

The US school bus business, its biggest source of profit, has seen its profits and margins increase. UK bus and UK rail have also made more money.

So why is there such as big difference between adjusted profits and reported profits? The company has given a useful explanation in its results release.

Reconciliation of operating profit/(loss) to adjusted operating profit	**Year to 31 March 2019 £m**	Year to 31 March 2018 £m
Operating profit/(loss)	**9.8**	(196.2)
Adjustments for:		
Other intangible asset amortisation charges	**29.9**	70.9
Restructuring and reorganisation costs	**24.1**	26.0
North America insurance provisions	**94.8**	32.7
SWR onerous contract provision	**145.9**	–
Gain on disposal of property	**(9.3)**	–
Guaranteed minimum pensions charge	**21.5**	–
Loss on disposal/impairment charges	**16.2**	–
Greyhound impairment charges	–	277.3
TPE onerous contract provision	–	106.3
Total operating profit adjustments	**323.1**	513.2
Adjusted operating profit (note 3)	**332.9**	317.0

Source: Annual report

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Restructuring costs are a regular occurrence in First Group's accounts, which raise the question as to whether they are generally exceptional or one-off and not just a regular cost of doing business. The big issue of contention is the use of provisions to do with self insurance of its US buses and the onerous contract provision for its South West Rail franchise.

Provisions are amounts of money set aside to cover known and quantifiable future liabilities. They can be perfectly reasonable, but they have the potential to flatter a company's adjusted profits in the future. This is because the increase in the provision can be treated as an exceptional item and kept away from the adjusted profits figure. When the provision is used up – or utilised – this can protect the adjusted profit figure from the costs incurred because they have been recognised upfront in the past. Some companies to their credit do not let this flatter adjusted profits.

FirstGroup has lots of provisions on its balance sheet and the number is getting bigger.

19 Provisions

	2019 £m	2018 £m
Insurance claims	**292.7**	231.7
Legal and other	**35.5**	28.1
TPE onerous contract	**76.6**	79.2
SWR onerous contract	**125.5**	–
Pensions	**1.7**	2.0
Non-current liabilities	**532.0**	341.0

Source: Annual report

Let's look at the insurance claims one first.

	Insurance claims £m	Legal and other £m	TPE onerous contract £m	SWR onerous contract £m	Pensions £m	Total £m
At 1 April 2018	368.8	67.6	106.3	–	2.0	544.7
Charged to the income statement	278.5	39.1	–	145.9	–	463.5
Utilised in the year	(210.0)	(40.5)	(0.5)	–	(0.3)	(251.3)
Notional interest	11.0	3.6	1.1	–	–	15.7
Foreign exchange movements	23.5	1.8	–	–	–	25.3
At 31 March 2019	**471.8**	**71.6**	**106.9**	**145.9**	**1.7**	**797.9**
Current liabilities	**179.1**	**36.1**	**30.3**	**20.4**	**–**	**265.9**
Non-current liabilities	**292.7**	**35.5**	**76.6**	**125.5**	**1.7**	**532.0**
At 31 March 2019	**471.8**	**71.6**	**106.9**	**145.9**	**1.7**	**797.9**

Source: Annual report

FirstGroup self-insures its US buses. Every year it makes a provision based on an estimate on what it claims costs will be for the year, and this reduces profits. These claims can take up to six years to be resolved, so there is usually a difference between the amount expensed and the cash paid out when the provision is utilised.

First Group Insurance Provision (£m)	Reduction in adj profit	Cash paid	Difference
2013	135.1	173.1	-38
2014	144.5	176.1	-31.6
2015	142.5	163.7	-21.2
2016	172.9	153.6	19.3
2017	162.5	194.3	-31.8
2018	196.5	192.7	3.8
2019	183.7	210	-26.3
Cumulative	1137.7	1263.5	-125.8

Source:Investors Chronicle

We can see that in five of the past seven years, FirstGroup has paid out more in cash than it has expensed against its adjusted profits. (The £278.5m expensed in 2019 includes £94.8m treated as an exceptional and kept away from adjusted profits. The amount expensed against adjusted profits was £183.7m). The difference between the two figures has been £125.8m.

FirstGroup's £94.8m increase in its insurance provision this year is, to my mind, an admission that it has been historically under-provisioning for insurance claims and has overstated its profits. This effect has been ignored by analysts and investors who just look at adjusted profits. I wrote about this in my November 2018 magazine column entitled, 'The problem with profits'.

The other thing to be aware of is that there is just over £200m of provisioning for future losses on its rail franchises. When these losses are recognised, the provision will be utilised and there will be no effect on profits. Again, investors will get a misleading view of the profits and losses of the rail business in future years because the losses have been recognised upfront.

This is a shame as I think FirstGroup has some good bus assets with a potential to grow their real profits and cash flows. It is good to see that Greyhound – the long distance bus business in the US – is finally up for sale, as it has been a disaster. Getting out of rail would be a good idea, too.

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FirstGroup forecasts

	Year (£m)		
	2019	2020	2021
Turnover	7,079.40	7,312.00	7,044.50
Ebitda	719.1	727.8	727.7
Ebit	321.9	329.3	334.5
Pre-tax profit	215.9	237	246.2
Post-tax profit	162.9	179.7	189.4
EPS (p)	13.4	14.1	14.3
Dividend (p)	0.7	3.6	4.3
Capex	559.6	457.3	457.9
Free cash flow	119	170.1	182.1
Net borrowing	1,057.90	928.4	825.5

Source: SharePad

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