



## Phil Oakley's Weekly Round-Up

*My Fantasy Sipp is now back above water for the year to date and this week I've been making some changes*

### Fantasy Sipp & UK Quality shares performance

	1 month	Portfolio total returns (%)		
		Year to date	1 year	2 years
Scottish Mortgage Investment Trust	17.2	29.4	51.2	47.6
Smithson Investment Trust	14.2	14.0	27.6	-
LF Blue Whale Growth Fund	10.9	11.5	21.5	38.2
Mid Wynd International Inv Trust	13.2	8.6	24.6	28.9
Fundsmith Equity T Acc	7.3	6.5	13.5	30.7
Lindsell Train Global Funds	7.9	1.9	3.8	22.1
Martin Currie Global Portfolio Trust	7.6	1.5	11.6	26.7
Vanguard S&P 500 ETF	8.5	1.4	14.7	24.5
<b>Phil Oakley Fantasy Sipp</b>	<b>8.0</b>	<b>0.8</b>	<b>11.6</b>	<b>29.0</b>
Finsbury Growth & Income Trust	8.6	-5.4	-3.0	8.0
<b>Phil Oakley UK Quality Shares</b>	<b>9.5</b>	<b>-7.6</b>	<b>-</b>	<b>-</b>
Castlefield CFP SDL UK Buffettology Fund	9.0	-10.0	-1.2	7.9
Vanguard FTSE 100 ETF	9.2	-15.7	-8.7	-11.0
FTSE All-Share – Total Return	9.6	-15.8	-8.1	-11.2
Vanguard FTSE 250 UCITS ETF	10.2	-19.2	-4.3	-11.3

Source: SharePad

I've been doing a bit of tinkering with the Fantasy Sipp portfolio, which is now making money year to date, although lags an S&P 500 ETF and many leading quality funds so far in 2020.

I have top-sliced positions in Visa, Moodys, Amazon and Avon Rubber, which have all performed very well to buy a position in US retailer Costco. I have written an analysis of the company in this week's Investors Chronicle, which explains why I like it so much. The shares are expensive, but I think it has a fantastic business model that can grow the value of the business from where it is now over the years ahead. I used some dividend income to add to the position in Smith & Nephew.

The UK Quality Shares portfolio has staged something of a recovery, as optimism about the opening up of economies has seen many battered shares bounce back. The portfolio is down 7.6 per cent year to date, compared with a fall of 15.8 per cent in the FTSE All-Share index, which is a bit better than a few weeks ago, but still a significant loss.

Alpha Production Editor: Sameera Hai Baig

The portfolio is an experiment on quality growth investing in the UK market. This is a difficult task given the scarcity of high quality businesses available at reasonable valuations, but I will also admit that I have made some mistakes in stock selection as the lack of resilience of businesses have been exposed by the lockdown.

### **Stay the course by investing in good companies**

There is a huge amount of chatter about the disconnect between the buoyancy of stock markets and the struggles of many people in the real economy. I agree that this is puzzling, but is largely down to lots of money printing and the lack of yield elsewhere. This is complemented by a fear of missing out on a rally and the momentum trade it has created.

I do believe that many of the problems the real economy faces will improve sooner or later, but I retain my view that things are unlikely to get back to where they were any time soon. This is not just down to issues such as social distancing and the difficulties it presents many businesses with, but is based on a view that the underlying health of economies – and consumers in particular – was weak before the coronavirus came about.

Wage growth has been weak for many years and there is only so much debt people can take on to keep spending levels high. Falling prices which worry central bankers are therefore good for many households providing their incomes do not fall by a greater amount which is sadly a reality for many.

The Federal Reserve in the US is likely to keep on doing what it has been doing for the last quarter of a century, which is propping up the bond market and with it the stock market and property markets as well. That said, there are limits to how far this can go.

The line may already have been crossed as to when people think that the stock markets are rigged in favour of the one percenters. Wealth inequality has been worsened by money printing since 2008 and doing it again in much larger amounts now is just making things worse. Americans are kicking off and are on the streets at the moment on another matter, but rising levels of unemployment while Wall Street is getting richer is an ill wind that may eventually blow no good.

The political situation in the US has the potential to bring the party to an end eventually. It is not inconceivable that the Democrats could control the White House and both Houses of Congress by January next year. Whether they would be emboldened to pursue populist, anti-capitalist

policies to right the perceived wrongs of recent years remains to be seen but cannot be ruled out. Having just finished reading Jonathan Tepper's and Denise Hearn's excellent *The Myth of Capitalism*, I can't help thinking that capitalism isn't working and there is a better way.

Having said this, I still feel we are some way from money printing feeding through into harmful, general price inflation, as I believe the deflationary forces from economic lockdowns are currently so big. As with 2008, the new money is not going into the pockets of the general population and is yet to create a situation where too much money is chasing too few goods, even though there are some supply issues in certain parts of the economy.

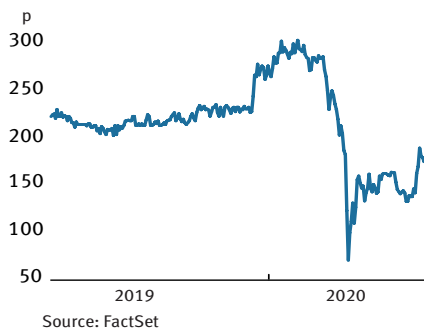
In the UK we are seeing signs of consumer retrenchment with record amounts of money used to pay off credit card debt. Construction activity remains weak and is not expected to recover quickly. These are not the seeds from which a rampant economic recovery and inflation take hold.

I remain very bearish on the UK economy and believe the short-term rally in sterling against the US dollar could be a brief one. The government's finances are in a precarious state and raises the possibility that taxes will have to be increased to pay for the lockdown bill.

The tax base to pay these bills is not particularly strong given the cash cows of property and oil that have been used in the past are now somewhat fallow. Pension pots are another matter and I think the temptation to scrap higher rate tax relief on pension contributions must be becoming very difficult to resist.

Despite the huge list of things to worry about and high stock market valuations, some exposure to shares still seems sensible. My view is that buying the shares of good companies with strong defendable business models and global earnings streams is still the right way to invest for the long haul, but I also think that a relief rally in beaten up UK shares in travel and consumer-related sectors cannot be ruled out if we avoid a second wave of coronavirus.

## Hollywood Bowl share price



## Hollywood Bowl

Half-year results from **Hollywood Bowl (BOWL)** showed what a good business it is – when its centres are open.

Like-for-like sales increased by 8.6 per cent, driven by a 6.4 per cent increase in the number of games played and a 2.1 per cent increase in spend per game to £10.07. Underlying earnings before interest, tax, depreciation and amortisation (Ebitda) until the end of February was up by 12.1 per cent, but the impact of the coronavirus lockdown meant that by the end of March – the end of its half year –

it was only up by 1.2 per cent.

With all its bowling centres currently closed, the business has no revenues right now, but the damage to profits over the next few months seems to have been well constrained. Most of the staff are being paid under the government's furlough scheme, while the company has agreed deals with its landlords to reduce its rent bill. All non-essential investment spending has been put on hold for now. This means that the company's monthly cash burn while its centres are closed is expected to be a very modest £1.2m.

The key question surrounds what kind of business will Hollywood Bowl be, and how much money it will make when the centres open up again sometime in July.

The short answer is not as good as it was before the lockdown.

The company is planning to significantly restrict the revenue-generating capacity of its centres. Games will only be played on alternate bowling lanes with customers having to pre-book to play at peak times. Off-peak trading hours will be reduced.

Social distancing will be implemented in queues for its food and drink facilities where menus will also be reduced. What this seems to indicate is that revenues and profits are going to be some way below previous levels and are unlikely to bounce back quickly.

The company's finances have been placed on a firm footing, which should mean that it is no danger of going bust. It has said that it could operate at 20 per cent of its 2019 activity levels and not run out of cash.

Longer term, I still like the outlook for this business. Its refurbishment programme has proven that it can lift revenues and profits on its existing centres and generate a good return on investment. The company also has a pipeline to open 10 new bowling centres over the next four years and add to its Puttstars mini golf centres where the initial customer response has been encouraging.

Making the assumption that one day things will get back somewhere near to what used to be considered normal, there is still a very decent business here. It offers very good value for money family entertainment with a business model that is very profitable and capable of generating decent levels of free cash flow, as evidenced by free cash flow margins of 15 per cent.

That said, it is not going to get back to this level of performance for a while and my guess is that investors might have to wait until 2022 before it does.

Assuming this business got back to generating free cash flow of £20m per year this would equate to 12.7p per share

and a free cash flow yield of 7.3 per cent at a share price of 175p. Depending on whether you want to count the capital payment in leases as capital expenditure (not an unreasonable thing to do in my opinion), then the current annual run rate of free cash flow is between £8m and £13.6m, which would give free cash flow yields of between 2.9 per cent and 4.9 per cent.

On a getting back to the normal assumption, I think there are grounds for thinking that Hollywood Bowl shares are cheap, but the risks associated with the business have undoubtedly increased. Whether families whose incomes are taking a beating will quickly return to bowling remains to be seen.

One point that is worth bearing in mind is that Hollywood Bowl tends to locate many of its centres close to the main cinema in towns and cities. Given the coronavirus has dealt a hammer blow to cinema attendance for the time being and probably for some time to come, it's probably going to have an adverse knock-on effect for visitors to Hollywood Bowl for a while.

This is a business that I have a lot of admiration for, but its exposure to a fragile UK consumer is its Achilles' heel. Its shares are still part of my UK Quality shares portfolio, but they are a candidate to be sold when I find something better to replace them with. I am also conscious that the shares have the potential to rally if sentiment towards opening up the UK economy improves, which may provide a better exit opportunity.

#### Hollywood Bowl: current forecasts

	2020	Year(£m) 2021	2022
Turnover	86.2	125.2	142.3
Ebitda	15.5	33.5	38.9
Ebit	4.8	23.3	27.5
Pre-tax profit	8.5	21.8	26.8
Post-tax profit	2.6	16.6	21.9
EPS (p)	3.8	11.4	14.2
Dividend (p)	1.1	6	7.6
Capex	14.1	16.6	18.2
Free cash flow	0.9	19.4	22.2
Net borrowing	8.1	-0.7	-9.1

Source: SharePad

## Forterra share price



## Forterra

Regular readers will know that I like **Forterra (FORT)** as a business and its shares are in the UK Quality shares portfolio.

I like it because it has substantial reserves of clay, which are scarce assets and a rather big barrier to competition. Its new brick-making facility being built in Leicestershire adds significant new capacity and gives the company the potential to replace a lot of imports coming into the UK market.

Under normal business conditions, the company is very profitable and can have operating margins of 20 per cent and a return on capital employed (ROCE) of more than 25 per cent. While the housebuilding industry is cyclical, this is offset by the fact that there is an undersupply of domestically-produced bricks in the UK and the company's strong position in supplying bricks for repairs and improvement projects.

All this is well and good, but if your main customers have stopped building houses and are likely to build fewer than expected for the next year or so, it's going to be a bit of a problem. This is the situation that Forterra is currently facing up to.

Revenues were down by 39 per cent in the five months to the end of May, but fell by 86 per cent in April and by 62 per cent in May. Daily dispatches of its bricks and blocks are now running at around half of 2019 levels.

Capacity has been cut with only 12 out of 18 brick-making facilities currently open, but all should be up and running by the end of July. That said, the industry outlook for residential construction is decidedly downbeat with production currently expected to be 20 per cent lower in 2021 than it was in 2019.

This has led Forterra to change its working shift patterns and mothball its concrete flooring plant – but not its precast concrete facility – in Derbyshire, which is expected to lead to the loss of around 225 jobs.

I find it a little bit concerning that the company's current revolving credit facility (RCF) of £150m is fully drawn, which leads me to think that it may have to ask shareholders for money if demand continues to be weak and its banks don't give it any more credit (which given its low previous debt levels it will ask for).

**Forterra: current forecasts**

	2020	Year(£m) 2021	2022
Turnover	293.6	364.6	372.6
Ebitda	54.7	76.1	78.7
Ebit	39	59.3	58.3
Pre-tax profit	32.4	55.7	59.2
Post-tax profit	32	45.3	46.9
EPS (p)	14.5	23.3	23.7
Dividend (p)	8.1	10.8	10.8
Capex	35.3	52.6	25.7
Free cash flow	1.1	20.5	37.6
Net borrowing	74	86.3	64.8

Source: SharePad

Current forecasts – especially for 2021 and 2022 – look like they will be slashed. I also wonder if the new facility in Leicestershire may see its opening delayed if demand means that its capacity utilisation could be some way below initial expectations.

As with many companies right now, valuation is tricky. The company is not likely to get back to making pre-tax profits of £65m – as it did in 2018 – anytime soon.

Based on expectations of £32m of pre-tax profits in 2020 and EPS of 14.5p, the shares trade on a forecast PE of just over 15 times at a share price of 221p. That does not look too expensive based on depressed profits, but a lot depends on the health of its housebuilding customers and what they do with their land banks and the number of homes they build on them.

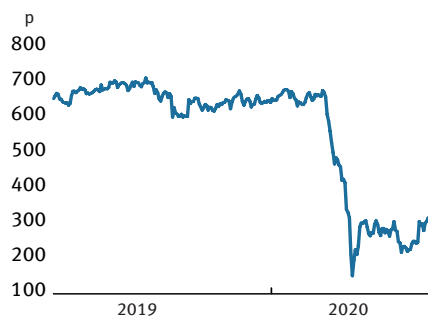
I've long been sceptical about the working of the UK new-build housing market and the artificial inflation of selling prices through the Help to Buy scheme. This has led new-builds to be priced at unsustainable premiums, compared with the existing housing stock, and a correction is possible and arguably needed.

If mortgage lenders now think that the world has changed – and not for the better – then they may think that a 25 per cent taxpayer-funded equity buffer doesn't protect them enough from potential price falls. If so, then new-build prices will fall and housebuilders will have to write down the value of their land – perhaps by large amounts. This in turn will probably lead to fewer houses being built long past 2021 and this is not good for brickmakers such as Forterra.

I can't help thinking that Forterra is another example of how difficult it is for UK investors to put together a portfolio of UK quality shares and I feel I have come up short here by including it in my UK fantasy portfolio.



## SSP share price



Source: FactSet

## SSP

The striking investment theme of the coronavirus and the lockdowns in response to it is that many businesses which were seen as very sound before it came along are now seen as being very vulnerable.

Not so long ago, **SSP's (SSPG)** food and drink shops with captive customers at railway stations, motorway service stations and airports across the world was rightly seen as a very good business. As with Hollywood Bowl, the economics are horrible when people don't travel and there also has to be plenty of uncertainty as to when – or even if – the level of travel gets back to previous levels.

Half-year profits were wiped out as revealed by the company this week.

SSP has been in survival mode. It raised £209m from a share placing in March and this week asked shareholders to reinvest their final dividend for 2019 (6p per share), which could raise another £26.8m. In the end, £11m was raised.

This should see it through even the most dire scenario, which is a good job because the short-term outlook is grim, but will hopefully be better than the worst-case outcome.

Based on the very pessimistic assumption of a revenue decline of 85 per cent in the second half of 2020 – equivalent to a drop of £1.4bn – operating profits could be between £180m and £250m lower than in 2019. Throw in a large working capital outflow (the company has negative working capital and cash inflows when revenues are growing) and the second-half cash outflow could be between £340m and £440m.

Even if this happened the company would still have between £310m and £410m of spare cash available, which means it should be ok.

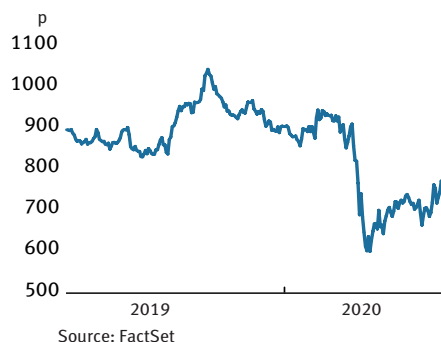
When things get up and running again the company's business position looks very decent. It has won new contracts and will initially be helped by the removal of minimum annual rents, reduced concession fees and the reduction of fees to its franchise partners.

If this company could get back to making as much money as it used to then, as with Hollywood Bowl, the case can be made for arguing that the shares are undervalued and possibly considerably so. With all the extra shares that have been issued, net profits of £131m in 2019 would equate to EPS of 24.4p, which would value the business at 12.9 times earnings at a share price of 315p.

The trouble is it may take many years before it gets back to this level. That said, given how hard the shares have been hammered in 2020, I see this as a share with considerable recovery potential with some positive sentiment behind it.



## Britvic share price



## SSP: current forecasts

	2020	Year(£m) 2021	2022
Turnover	1,630.10	2,736.70	2,957.50
Ebitda	-21.7	307.8	351.4
Ebit	-139.6	195.5	230.8
Pre-tax profit	-167.1	172.9	217.7
Post-tax profit	-158.7	105.8	142.3
EPS (p)	-32	22.7	27.9
Dividend (p)	-	9.4	10.9
Capex	120.1	130.4	136.4
Free cash flow	-430.2	199.9	152.4
Net borrowing	613.1	475.1	385.1
NAV	107.1	212.8	340.2
Like-for-like sales growth (%)	-43.4	27.1	3.5

Source: SharePad

## Britvic

I think **Britvic (BVIC)** is a very solid business. Its core UK operations (61 per cent of total revenues in 2019) are underpinned by its fizzy drinks business, with three very powerful low or no sugar brands in diet versions of Pepsi, 7-UP and Tango taking market share. Robinsons remains a very strong brand in the UK stills drinks market. J2O juice drinks have a strong presence in pubs and restaurants when they are open.

Elsewhere, Brazil is seeing some nice growth with sales volumes up by more than 17 per cent in the six months to March 2020. Ireland, France and the other international businesses are decidedly lacklustre.

The bull case for Britvic shares is the strength of the UK fizzy drinks business complemented by the benefits of significant investment in its production and distribution network. In more normal times, this has the potential for steady growth and the generation of lots of free cash flow.

Longer term, I think this case is still intact, but the closure of pubs, restaurants and leisure businesses has naturally done a lot of damage to the company's on-trade and on-the-go sales. While take home sales have increased, this has come at the expense of margin, as packaging and pricing are different than the more profitable concentrate which is sold into the on-trade.

While half-year results were solid enough, the key concern is that the closure of pubs and restaurants is causing Britvic to lose £12m-£18m per month, which could wipe out its annual profits if it continued for a year.

The cash flow statement looked a bit of a mess with a huge working capital outflow due to indirect tax payments, which should be a one-off. Capex has come down now that its major investment projects have been completed.

The other area to watch for, in terms of a cash flow boost

concerns, is the company's final salary pension scheme where there is a net surplus of £212m. The main UK scheme has been closed to new members since 2002 and to future accrual since 2011. Yet, the company is still paying £15m per year into it. Pension fund surpluses and deficits have the potential to move around a lot, but it's not unreasonable to think that the current actuarial review of the UK scheme might see lower cash payments going forward and a boost to free cash flow.

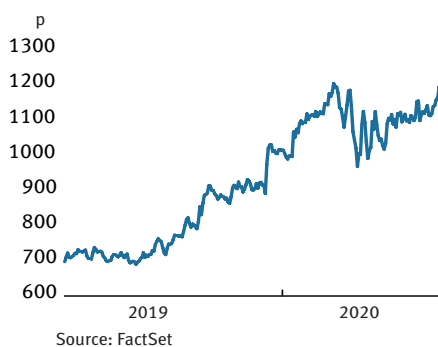
#### Britvic: current forecasts

	2020	Year(£m) 2021	2022
Turnover	1,372.40	1,491.60	1,539.70
Ebitda	216.8	263.3	278.9
Ebit	155.8	200.9	214.4
Pre-tax profit	126.3	177	194.4
Post-tax profit	104.1	146.4	158.2
EPS (p)	40.6	55.4	59.5
Dividend (p)	22.8	28.3	30.2
Capex	50	73	71.4
Free cash flow	83.5	140.9	153.1
Net borrowing	560.9	499.2	443.5

Source: SharePad

Current forecasts look like they will have to come down, but I see Britvic as a business in more normal times being capable of generating free cash flow for shareholders of £120m/45.3p per share. This would equate to a free cash flow yield of 5.9 per cent at a share price of 772p, which would be a reasonable value in my view, although it may be a couple of years before it can deliver.

#### Pennon share price



#### Pennon

**Pennon (PNN)** has been the best performing UK-listed water company for some time. It has done this by doing its job for customers well and earning a sector leading return on regulated equity of 11.9 per cent. This has allowed it to grow its annual dividend by 4 per cent more than inflation for the past five years.

It also succeeded in creating a very valuable waste business in Viridor, which it has managed to sell for an eye-watering price of £4.2bn to a private equity buyer. The £3.7bn of cash that will be received later this year will be used to pay down debt and the pension deficit, as well as some form of one-off payment to shareholders.

The sale of Viridor will reduce Pennon's ongoing profits and it is therefore not a surprise to discover that the future annual dividends will be lower after Viridor leaves the group. What shareholders might find a little bit surprising is how big the dividend cut is going to be.

**Pennon: 2019-20 EPS contribution and dividend**

	SWW	Viridor	Pennon total
Profit after tax (£m)	147.8	111.5	259.3
Weighted average shares (m)	420.2	420.2	420.2
EPS (p)	35.2	26.5	61.7
Dividend per share (p)			43.77
Dividend cover			1.41

Source: Pennon & IC

We can see that South West Water (SWW) contributed 35.2p or 57 per cent of Pennon's adjusted EPS last year. However, the management says that the sale of Viridor is equivalent to 22.66p of the 43.77p total dividend for 2020, despite accounting for a lower share of the profits. This leaves a base dividend of 21.11p for SWW, which will be increased by CPIH inflation (currently 0.9 per cent) plus 2 per cent for the next five years.

My very rough guess is that management has taken the £3.7bn cash proceeds for Viridor and compared it with £3.5bn regulatory capital value for the water business, which would mean Viridor is 51.5 per cent of total company value. Applying this to 43.77p of total dividend for 2020 would give a Viridor share of 22.5p, which is close to 22.66p.

If true then I think there is a reason for being a bit annoyed, as dividends are paid out of income not value. Even with lower regulated water profits following the recent price review, my back of a fag packet type forecast indicates that adjusted EPS ex Viridor would be close to 30p and could be paid out as dividends given the much lower expected debt levels.

The new dividend policy would imply a 2021 dividend of 21.72p per share, which would give the shares a dividend yield of just 1.9 per cent at a share price of 1,133p, compared with a historic yield of 3.9 per cent. No doubt a large special dividend (440p per share would be half the cash proceeds from Viridor) would go some way to placating investors, but the income attractions of Pennon shares would appear to no longer exist.

© The Financial Times Limited 2020. Investors Chronicle is a trademark of The Financial Times Limited. “Financial Times” and “FT” are registered trademarks and service marks of The Financial Times Limited. All rights reserved. No part of this publication or information contained within it may be commercially exploited in any way without prior permission in writing from the editor.

**Permitted Use:** By purchasing this magazine, you agree that the intellectual property rights (including copyright and database rights) in its content belong to The Financial Times Limited and/or its licensors. This magazine is for your own personal, non-commercial use. You must not use any of the content as part of any commercial product or service, including without limitation any which reduces the need for third parties to use the Investors Chronicle magazine and/or website, or which creates revenue from the content, or which is to the detriment of our own ability to generate revenues from that content. For example, you must not use any of our content in any syndication, content aggregation, news aggregation, tips aggregation, library, archive or similar service, and you must not capture any such content, whether systematically, regularly or otherwise, in any form of database without our prior written permission. These contractual rights are without prejudice to our rights to protect our intellectual property rights under law.

Investors Chronicle adheres to a self-regulation regime under the FT Editorial Code of Practice: A link to the FT Editorial Code of Practice can be found at [www.ft.com/editorialcode](http://www.ft.com/editorialcode). Many of the charts in the magazine are based on material supplied by Thomson Datastream and S&P Capital IQ.

Material (including tips) contained in this magazine is for general information only and is not intended to be relied upon by individual readers in making (or refraining from making) any specific investment decision. Appropriate independent advice should be obtained before making any such decisions. The Financial Times Limited does not accept any liability for any loss suffered by any reader as a result of any such decision.

ISSN 0261-3115.