Investors' Chronicle | Alpha

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Getting the right balance between quality, valuation and growth

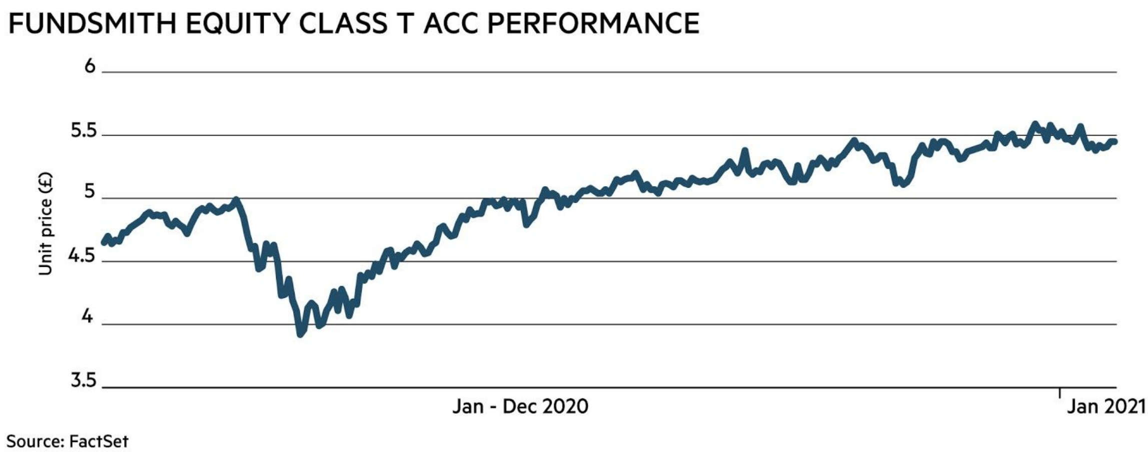
22 January 2021

Are quality shares in a bubble?

One of the biggest problems that has faced investors in recent years is how much to pay up for the shares of quality growth businesses. With hindsight, I have been bad at recognising how much you can pay – quite a lot is the answer – for quality and dependable growth in a low interest rate world.

Report by Phil Oakley

One of the biggest beneficiaries of the boom in large-cap quality growth stocks has been Terry Smith with his Fundsmith equity fund. The annual letter was released this week and, as usual, it is a very interesting read.



Since inception, Terry has told his investors what the weighted average trailing free cash flow yield of his portfolio has been at the end of the year. Since the 2012 letter, he has also told them the weighted average free cash flow growth of the portfolio.

These numbers are very useful as it allows someone like me to have a go at working out what has been the driver of Terry's excellent investment returns. You can break it down into the change in valuation, free cash flow growth, trading costs and currency effects.

Fundsmith has done a brilliant job for its investors, with cumulative total returns of 449 per cent between starting out in November 2010 and December 2020.

FundSmith: Portfolio FCF yield, FCF growth and total returns

Year	FCF yield	FCF growth	Portfolio return
2011	5.8%		8.4%
2012	5.7%	9.6%	12.5%
2013	5.1%	6.6%	25.3%
2014	4.5%	7.0%	23.3%
2015	4.3%	9.7%	15.7%
2016	4.4%	11.0%	28.2%
2017	3.7%	13.0%	22.0%
2018	4.0%	8.0%	2.2%
2019	3.4%	9.0%	25.6%
2020	2.8%	8.0%	18.3%

Source: Fundsmith

The fund has had a big following wind from rising valuation or falling free cash flow yields as interest rates on bonds have fallen. At the end of 2010, the weighted average free cash flow yield was 7 per cent. It had fallen to just 2.8 per cent at the end of 2020.

But the fund has invested in very good companies that have been able to consistently grow their free cash flows – something that conventional bonds cannot do. It is the combination of falling yields and free cash flow growth that has driven the valuation of the shares in his portfolio.

To see how this works, I have created an example.

Value drivers of Fundsmith portfolio

	FCF	Value at FCF yields	Change in value
Starting	100	1724	
2012	109.6	1923	11.5%
2013	116.8	2291	19.1%
2014	125.0	2778	21.3%
2015	137.1	3189	14.8%
2016	152.2	3460	8.5%
2017	172.0	4649	34.4%
2018	185.8	4644	-0.1%
2019	202.5	5956	28.2%
2020	218.7	7810	31.1%

Source: Fundsmith & Investors Chronicle

I've taken the portfolio from the end of 2011 as free cash flow growth was only disclosed from 2012 onwards. A base FCF figure of 100 is divided by the trailing free cash flow yield of 5.8 per cent to give a starting portfolio value of 1724.

A year later the FCF has grown to 109.6 (9.6 per cent growth) and is capitalised at a free cash flow yield of 5.7 per cent. This gives a year end value of 1,923 or portfolio growth of 11.5 per cent. The exercise is then continued until the end of 2020.

What needs to be taken into account is that the total returns are expressed in pounds sterling to predominantly UK investors. The returns of the core portfolio is largely in foreign currency.

By working out the core portfolio return and knowing the reported sterling return we can work out the key drivers of Fundsmith Equity to its investors since the end of 2011, by individual year and cumulatively.

The components of FundSmith returns

Year	Change in valuation	Growth	Return	Other	Portfolio return
2012	1.8%	9.6%	11.5%	1.0%	12.5%
2013	11.8%	6.6%	19.1%	6.2%	25.3%
2014	13.3%	7.0%	21.3%	2.0%	23.3%
2015	4.7%	9.7%	14.8%	0.9%	15.7%
2016	-2.3%	11.0%	8.5%	19.7%	28.2%
2017	18.9%	13.0%	34.4%	-12.4%	22.0%
2018	-7.5%	8.0%	-0.1%	2.3%	2.2%

2019	17.6%	9.0%	28.2%	-2.6%	25.6%
2020	21.4%	8.0%	31.1%	-12.8%	18.3%
Cumulative	107.1%	118.7%	353.0%	24.6%	377.6%

Source: Fundsmith & Investors Chronicle

We can look at the absolute changes in value and break it down into what has come from changes in free cash flow yield and what has come from free cash flow growth. To work out the change that has come from valuation, we take the previous year's FCF and divide it by the current year's FCF yield. The difference in total valuation is explained by FCF growth.

Changes in Fundsmith

Year	Change in value	From valuation	From growth
2012	199	30	168
2013	368	226	142
2014	487	305	182
2015	411	129	282
2016	270	-72	343
2017	1189	655	535
2018	-5	-349	344
2019	1311	820	492
2020	1855	1276	579
Cumulative	6086	3020	3066

Source: Investors Chronicle

We can see that the cumulative total returns before costs and currency of 353 per cent has pretty much been evenly split between the fall in free cash flow yields and growth in free cash flow. The total portfolio returns of 377.6 per cent have not had a small currency benefit from what I can see. The pound against the US dollar has depreciated by 11.2 per cent in the time period and total charges would have been 9-10 per cent.

The growth performance of Fundsmith has therefore been good, but valuation gains can be taken away. In his 2020 annual letter, Terry says the 2.8 per cent free cash flow yield of his fund "makes us nervous" and that "changes in valuation are finite and reversible." I agree with these comments.

What this perhaps adds weight to is the view that shares are very highly valued, and that share prices perhaps cannot keep on rising faster than free cash flow growth for much longer, and that some kind of correction is very possible.

Terry says that a rise in interest rates that would trigger a correction is not on the horizon, but he does not mention a potential rise in inflation which is worrying some people right now.

His definition of not overpaying is to get a better free cash flow yield than is available on government bonds. Given that bond yields have been manipulated by central bankers, he sets a floor to yields of 1 per cent more than inflation.

Long-term inflation expectations in the US are around 2 per cent right now when comparing the yields between treasuries and TIPS. Add 1 per cent to that and you get 3 per cent as a minimum required return. Terry Smith and other quality investors are right to be nervous.

Fantasy Portfolios

UK Quality shares

Portfolio returns (%)	1 month	Year to date	1 year	2 years	3 years
Vanguard FTSE 100 ETF	2.9	3.8	-9.9	3.7	-2.4
FTSE All-Share – total return	3.0	3.5	-7.8	6.8	0.2
Vanguard FTSE 250 UCITS ETF	3.3	1.4	-3.4	15.4	7.0
Baillie Gifford UK Growth Fund	8.1	0.4	14.2	32.4	31.4
Castlefield CFP SDL UK Buffettology Fund	3.2	-0.5	0.9	24.7	28.7
Finsbury Growth & Income Trust	0.6	-0.7	-0.2	16.6	20.4
Phil Oakley UK Quality shares	**-0.3**	**-0.7**	**-4.4**		

Source: SharePad

Fantasy Sipp

Portfolio returns (%)	1 month	Year to date	1 year	2 years	3 years
Scottish Mortgage Investment Trust	5.7	3.2	110.0	157.0	169.0
Mid Wynd International Inv Trust	7.6	3.1	20.6	59.2	47.4
Vanguard S&P 500 ETF	1.7	2.0	10.8	39.3	44.4
iShares MSCI World Acc	1.7	1.9	9.7	34.0	33.2
iShares NASDAQ 100 UCITS ETF	1.8	1.6	36.3	83.3	97.4
Martin Currie Global Portfolio Trust	4.9	0.9	17.0	58.1	56.0
Fundsmith Equity T Acc	2.6	-1.7	16.4	48.1	52.2

Smithson Investment Trust	0.7	-2.5	23.9	61.2	
Phil Oakley Fantasy Sipp	**-2.1**	**-2.5**	**4.8**	**37.8**	**43.9**
LF Blue Whale Growth Fund	3.1	-2.8	21.6	56.3	71.1
Lindsell Train Investment Trust	3.3	-3.8	16.3	19.1	74.7

Source: SharePad

Companies round-up

The eight companies this week are:

- Experian
- Burberry
- Diploma
- WH Smith
- Watkin Jones
- JD Wetherspoon
- Sage
- Pets at Home

Experian

I think **Experian (EXPN)** is a very good business. It is in the UK Quality Shares portfolio as a play on data, the continued growth in consumer credit and the increasing digitisation of commercial decision making and purchases.

The business is underpinned by its leading position in the credit referencing market and the huge value that its credit data has not just for lending decisions but to create other data analytical products and services. It is a business that is very hard to replicate and has few competitors globally.

Experian not only helps lenders to make better decisions when extending credit or loans, but it can help with other issues such as fraud, identity theft and customer engagement. The business has branched out from selling to financial institutions to car dealers, mobile phone companies, retailers and private healthcare providers.

As many consumer purchases are now made on credit, it has also had a major push on helping people improve their credit ratings by offering free access to credit reports. This has then allowed them to upsell to paid products, which allow users to boost their credit rating and protect themselves from fraud.

In short, there is a good business here that should be able to grow steadily, while earning good returns on investment.

As we have seen over the last year, businesses cannot grow all the time, but they can show their resilience in tough times. Experian seems to have done this quite well.

Third-quarter trading has been robust with organic revenue growth of 7 per cent. This was driven by a very strong growth in North America – mortgage refinancing has been a major contributor here – and Asia. Good performances in Latin America have been offset by continued currency depreciation. The UK and Ireland has been very sluggish, reflecting a big economic shock from Covid-19.

% change in revenue from ongoing activities year-on-year for the three months ended 31 December 2020

Ongoing activities only	**Total revenue growth %**	**Total revenue growth %**	**Organic revenue growth %**
	At actual exchange rates[1]	**At constant exchange rates**	**At constant exchange rates**
North America	11	11	9
Latin America	(11)	13	13
UK and Ireland	1	(2)	(2)
EMEA/Asia Pacific	21	16	(11)
Total global	**7**	**10**	**7**

1 Experian reports in US dollars.

Source: Experian

The revenue growth has been coming from the Consumer side of the business, while Data has done well. Decisioning software sales have been weak, which offset a good performance from Decisioning in Health and fraud areas.

% change in organic revenue year-on-year for the three months ended 31 December 2020

Organic revenue growth %[2]	*Data*	*Decisioning*	**B2B[3]**	**Consumer Services**	**Total**
North America	7	2	6	18	**9**
Latin America	1	5	2	178	**13**
UK and Ireland	(1)	(5)	(2)	1	**(2)**
EMEA/Asia Pacific	(8)	(15)	(11)	n/a	**(11)**
Total global	**4**	**(1)**	**2**	**22**	7

Source: Experian

The company has entered the fourth quarter in a reasonable position and expects continued organic revenue growth of 3 to 5 per cent. Along with the third-quarter performance, this is an encouraging improvement from the first half of the year when organic revenue growth was just 2 per cent.

This should be enough to offset the underlying cost growth in the business for the year as a whole, but nothing more. Full-year operating profit is expected to be in the range of $1,360m-$1,380m, which would be a flat result year on year.

Experian forecasts

Year ($m)	2021	2022	2023
Turnover	5,291.90	5,779.40	6,191.30
Ebitda	1,820.80	2,016.30	2,206.10
Ebit	1,355.80	1,540.10	1,697.50
Pre-tax profit	1,257.70	1,447.70	1,615.60
Post-tax profit	919.6	1,062.10	1,192.30
EPS (¢)	100.7	115.8	129.1
Dividend (p)	34.7	38	41.9
Capex	468.6	516.9	546.8
Free cash flow	865.4	1,039.30	1,133.20
Net borrowing	3,854.30	3,427.50	3,008.80

Source: SharePad

Analysts expect a decent profit recovery next year, as hopefully the economy improves, which fits in with my view that Experian should be a steady grower if all goes well. At 2,645p, the shares trade on a rolling one year forecast PE of 32 times, which is hardly going to attract bargain hunters, but is currently the going rate for a global business with a strong competitive positioning and a continued ability to grow. I'm happy sticking with it in the UK portfolio.

Burberry

Burberry (BRBY) is seen as a play on a growing luxury goods market and the rise of the monied middle class in countries such as China. It is, but I'm not convinced that this iconic British brand is that strong or big enough to compete with its global peers. If I wanted to gain exposure to this theme, I think there are better ways to play it, although admittedly not on the UK market.

Even before Covid-19, Burberry was struggling to grow as its revenues and profits have stagnated over the past five years. I think there's a very simple reason for this: its clothes, bags, shoes and jewellery are not seen as desirable as other global brands'.

Burberry has been trying to woo younger customers by using admirable young role models such as Marcus Rashford to promote its products. This seems to have had some success, but I remain to be convinced how many 20-somethings actually have the spare cash or desire to spend £1,300 on a trench coat or how many parents will buy £300 trainers for their children. In many cases, Burberry is a place which makes JD Sports and athleisure look like a positive bargain. It is no surprise to me that JD Sports has trounced Burberry in business performance and as an investment and I'd much rather own its shares.

I note with interest that Terry Smith has recently invested in LVMH. It has arguably some of the strongest fashion brands in the world in the form of Louis Vuitton, Christian Dior and Givenchy as well as Tag Heuer watches. In 2019, its fashion and leather business had profit margins of 33 per cent, which is more than twice the profit margin that Burberry makes. Valuation issues aside, which business would you rather own?

Burberry is trying to up its game and its third-quarter trading update released this week gave grounds for optimism, despite a difficult trading backdrop. About 15 per cent of its stores are currently closed, with a further 36 per cent on reduced opening hours.

Its decline in retail sales of 9 per cent is therefore not too bad in this context. It has been successful in selling more leather and outerwear products at full price, while digital full-priced sales increased by 50 per cent.

Strong sales in China and Korea saw Asia-Pacific like-for-like (LFL) sales increase by a healthy 11 per cent, but Europe and the Middle East saw sales crater by 37 per cent, while the Americas saw an 8 per cent decline.

The strength of full-priced sales means that the company is entering its fourth-quarter with a decent stock position and should not need big price discounts to shift it. This will help improve gross margins, but profits need volume growth in order to grow and that looks to be a few months away still.

Burberry forecasts

Year (£m)	2021	2022	2023
Turnover	2,290.20	2,587.30	2,736.10
Ebitda	619.2	742.9	818.6
Ebit	294.7	408.4	466.4
Pre-tax profit	287.2	391	450.4
Post-tax profit	207.9	300.5	339.4
EPS (p)	50.2	73.3	83.2
Dividend (p)	19.8	36.9	42.3
Capex	130.9	175.1	181.9
Free cash flow	229.1	303.1	361.4
Net borrowing	-640.5	-706.8	-986.2

Source: SharePad

It seems that the main investment case for Burberry right now is that it looks very cheap on recovered profits relative to the bigger global players. It's possible that someone will come and take it out, but I wouldn't bet on it. The valuation discount looks well deserved to me.

Diploma

Diploma (DPLM) is rightly seen as a very dependable business that has a proven ability to deliver modest rates of organic growth from its distribution businesses and complement it with value adding bolt on acquisitions. This week's first-quarter trading statement shows that the investment case is still intact, despite difficult end markets.

Diploma: Q1 trading performance

Sector performance		Q1
Life Sciences	Underlying	+8%
	Reported	+10%
Seals	Underlying	-2%
	Reported	-0%
Controls	Underlying	-1%
	Reported	+71%
Group	Underlying	+0%
	Reported	+24%

Source: Diploma

Life Sciences was the star performer with 8 per cent organic growth. This was driven by a very strong performance in Australia and Canada from sales of clinical diagnostic and speciality surgical equipment. Pent up demand from the backlog of operations and laboratory testing due to Covid-19 bodes well for continued growth in the second quarter, although a new lockdown in Canada may mute this a little.

The Seals business has held up well due to a strong aftermarket in North American repair shops. Controls has seen a very strong recovery since September when sales trends were very weak (down by nearly 20 per cent), but the really encouraging news from this business is that the recent acquisition of Windy City Wire (which sells low voltage wires and cables) is training ahead of expectations.

Some caution is needed with Controls, as it has benefited from stock building before the end of the UK's EU transition period in December, while the ongoing lockdown will hurt sales in the second quarter.

Diploma spent nearly £50m on acquisitions during the quarter, with one in Life Sciences and two in Seals.

There was no change in guidance for the full year with this update, but the main takeaway is the encouraging start at Windy City under Diploma's ownership. The size of this acquisition will transform the financial performance of Diploma in the years ahead, but the fact that the company paid a very good price for it means that better-than-expected profits have the potential to add more value for shareholders.

At 2,321p, Diploma's shares trade on a one-year rolling forecast PE of 30.3 times which is not cheap, but there's no reason why they should be. This will make it harder for new buyers to make really high returns from the shares, but those with a long-term view could still make reasonable gains, in my view.

Diploma forecasts

Year (£m)	2021	2022	2023
Turnover	722.3	770.6	812
Ebitda	141.1	152.6	159.9
Ebit	128	139.9	149.7
Pre-tax profit	123.1	134.5	143.4
Post-tax profit	93.8	102.9	109.9
EPS (p)	74.2	81.3	87.1
Dividend (p)	33.6	36.2	38.7
Capex	11.9	10.2	10.8
Free cash flow	86.7	99.1	110
Net borrowing	134.3	46.6	43.5

Source: SharePad

WH Smith

WH Smith (SMWH) has taken a real battering from Covid-19, but it continues to demonstrate why it is such a good retailer.

Its High Street stores in the UK are largely open as newsagents and the post offices that are located in them are seen as essential businesses. That said, selling space for entertainment and other non essential products has been closed off.

Christmas trading in the stores was fairly resilient at 92 per cent of the 2019 level, with good seasonal and working from home sales. Stock levels were very well controlled and discounting is not an issue to worry about. Unsurprisingly, sales have fallen off somewhat in January given the poor weather and a new lockdown in the UK.

WH Smith: Trends in monthly revenue vs 2019

	% of 2019 Revenue		
	High Street	**Travel**	**Group**
September 2020	89%	41%	59%
October 2020	92%	39%	59%
November 2020	82%	37%	58%
December 2020	92%	36%	67%
January 2021 to date	70%	30%	46%
Year to date	87%	37%	59%

Source: WH Smith

The Travel business – with the exception of sites at hospitals – is having a terrible time with the level of sales on a continuing downwards trend as airports and railway stations remain deserted.

The US travel business is faring better than elsewhere in the world and the integration of MRG with InMotion is going well. MRG has won four new airport concessions, which gives the US business a bigger revenue base when things get back to normal.

Travel Retail was a very good business before Covid-19 and was earning good returns in investment with steady growth. I have no doubt that it will be again in time, but I struggle to see how parts of it have not been permanently damaged.

Air travel is going to take a long time to recover, but the leisure market is likely to come back faster than business travel. I can see short haul leisure air travel doing okay, but I'm more concerned about business travel and long haul leisure air traffic.

Businesses will have learned how much they can do with video conferencing over the past year and are likely to travel less going forward. This has implications for leisure travel on long haul routes, as airlines have traditionally used the big profit they get from business class to subsidise the prices of economy tickets. Fewer business travelers could make economy tickets more expensive and therefore less attractive, which could mean fewer people buying books and food at WH Smith's airport shops.

Rail commuting passenger numbers in the UK are unlikely to recover to their previous levels, in my view. People will go back to the office, but probably not five days a week.

WH Smith forecasts

Year(£m)	2021	2022	2023
Turnover	991	1,349.60	1,512.70
Ebitda	142.9	288.1	342.3
Ebit	-48.8	103.6	159.9
Pre-tax profit	-58.2	92.5	155.5
Post-tax profit	-52.5	76.6	130.1
EPS (p)	-40.5	57.2	92.5
Dividend (p)	-	14.4	33.3
Capex	55.5	60.4	64.8
Free cash flow	-37.8	99.3	171.1
Net borrowing	576.5	520.3	413.9

Source: SharePad

WH Smith made £155m of pre-tax profit and 114.7p of earnings per share (EPS) back in 2019. Analysts currently expect pre-tax profits to recover to that level in 2023, but the increase in the number of shares in issue to finance the business means that 2019 EPS levels are still some way off.

The shares have recovered strongly from their 2020 lows, but are still unsurprisingly some way below their previous peak. At 1,756p, the shares trade on a 2023F PE of 19 times, which suggests to me that a decent recovery in profits is factored into the share price for now.

Watkins Jones

I've looked at **Watkin Jones (WJG)** on and off now for the past five years. It's a business I quite like. The bottom line is that it is essentially a home builder, but with a different and less risky business model compared to most of the UK-quoted housebuilders.

The company makes money by building purpose-built student accommodation (PBSA) apartments and apartments for the build-to-rent investment sector. It also builds affordable housing and has a lettings management business looking after students and buy-to-let apartments.

The business model is not as high risk as a typical housebuilder's, which means the profit margins are not as high, but they are still pretty reasonable. The company tends not to engage in speculative developments and only commits to a development when it is forward-sold to an investor or buyer. It gets paid for the building land almost immediately after a transaction, with cash paid in installments for developments.

2020 has not been an easy year with Covid-19 disruptions on building sites, but the company's profits have held up very well.

Profits from PBSA benefited from fewer land transactions, which typically have no margin attached to them. Build to Rent saw growing sales, while the Fresh Management business held up well as its revenues are largely fixed.

Watkin Jones: Profits and margins

£m	2020	2019
PBSA	226	246.1
BTR	94	77.4
Fresh	7.6	7.5
Residential	26.3	34.3
Other	0.25	9.5
Total Revenues:	354.15	374.8
Gross profit		
PBSA	54.3	54.9
BTR	14.9	13.8
Fresh	4.5	4.6
Residential	4.0	7.2
Other	-1.8	-0.3
Total Gross Profit	75.9	80.2
Admin Expenses	-24.2	-24.4
Operating profit	51.7	55.8
Gross margins		
PBSA	24.0%	22.3%
BTR	15.9%	17.8%
Fresh	59.2%	61.3%
Residential	15.2%	21.0%
Total	21.4%	21.4%
Op margin	14.6%	14.9%

Source: Watkin Jones & Investors Chronicle

The company remains very bullish about the outlook for its two main businesses. I share the optimism on build to rent, which is a growing part of the UK's housing mix and is set to increase significantly with the backing of many institutional investors.

Watkin Jones: BTR Pipeline

	BtR apartments					
	Total pipeline	FY21	FY22	FY23	FY24	FY25
Forward sold	928	857	71	—	—	—
Forward sales in negotiation	722	—	184	538	—	—
Sites secured with planning	—	—	—	—	—	—
Sites secured subject to planning	2,816	—	—	—	1,117	1,699
Total secured	4,466	857	255	538	1,117	1,699
Site acquisitions in legals	247	—	—	—	247	—
Total BtR pipeline	**4,713**	**857**	**255**	**538**	**1,364**	**1,699**

Source: Watkin Jones

Where I am more sceptical is in the demand for student accommodation. 2020 has been a real eye opener as to what students get for their money from going to university and if young people haven't questioned the cost and value of studying away from home for a degree, some may have changed their minds.

WJG is bullish and reckons the long-term demand – especially from foreign students – remains intact. Certainly for the next few years, its pipeline of PBSA paints a decent revenue and profit outlook for the business.

Watkin Jones: PBSA pipeline

	PBSA beds					
	Total pipeline	FY21	FY22	FY23	FY24	FY25
Forward sold	3,898	2,730	1,168	—	—	—
Forward sales in negotiation	714	462	—	252	—	—
Sites secured with planning	1,117	—	777	340	—	—
Sites secured subject to planning	2,181	—	—	1,846	335	—
Total secured	7,910	3,192	1,945	2,438	335	—
Site acquisitions in legals	1,998	—	—	662	570	766
Total PBSA pipeline	**9,908**	**3,192**	**1,945**	**3,100**	**905**	**766**

Source: Watkin Jones

The company reckons that BTR and PBSA revenues will be broadly equivalent at £300m each by 2023. Target gross margins are 15 per cent for BTR and 20 per cent for PBSA.

Watkin Jones: Potential PBSA and BTR sales

£m	2020	2021F	2022F	2023F
PBSA	226	290	275	300
BTR	94	150	250	300

Source: Watkin Jones & Investors Chronicle

The short- to medium-term revenue visibility is one of the key attractions for investors. With the assumption of stable profits from Fresh and a modest contribution from affordable housing projects, it looks as if this scenario is already factored into forecasts.

Watkin Jones forecasts

Year(£m)	2021	2022	2023
Turnover	454.2	506.1	644
Ebitda	63.4	67.1	89.8
Ebit	53	59	84.3
Pre-tax profit	47.4	54.9	78.7
Post-tax profit	45.9	52.1	73.8
EPS (p)	15.1	17.4	25.2
Dividend (p)	7.6	8.7	12.6
Capex	0.2	0.2	0.2
Free cash flow	18.9	23.1	45.6
Net borrowing	-84.5	-91	-128.6

Source: SharePad

The shares will also interest income-seekers with the forecast dividend yield in 2023 of 6.3 per cent at the current share price.

Looking further out, the outlook for student accommodation demand is a slight concern for me, but I also accept that a lot of current university accommodation is becoming tired, while the price differential between PBSA and a house share is becoming more favourable. I do see BTR as a source of forecast upgrades, though.

I wouldn't say that this is a business that excites me right now, but I think the risk-reward trade-off is better than owning housebuilder shares.

JD Wetherspoon

Regular readers will know that I think **JD Wetherspoon (JDW)** has the best and most productive business model in the UK managed pub sector. Like all the other pub companies, it is not making any money at the moment as the pubs are all shut.

The company is not in danger of going bust. It had £139.1m of liquidity as of 14 January and raised a further £137.7m by selling 8.37m new shares this week at £9 each. The business is currently burning cash at a rate of around £4m per week.

The cash raise looks like it could be put to good use as the company wants to buy pubs in central London, keep on buying the freeholds of its current leasehold pubs and buying properties next to its successful pubs. It is doing this to exploit depressed property valuations which could work out very well if the London pub trade gets back to something like it was in 2019.

One of the things I really like about this company is the level of disclosure it gives to investors. It really helps with trying to understand how the business works. It has given a range of scenarios based on the recovery of revenues back to 2019 levels. It gives a figure for owner earnings, which is free cash flow after maintenance expenditure on pubs has been taken into account,

The best case scenario it is giving at the moment is that revenues get back to those levels in 2022 following a decline and a bigger loss in 2021 than 2020. Note that pre-tax profits are not expected to be at the same level in 2022 as they were in 2019.

This would give free cash flow per share of 90.1p in 2022 and 99.4p in 2023 based on the post equity placing shares in issue (I have not adjusted debt or interest payments). This would give prospective free cash flow yields of 7.3 per cent and 8 per cent at the current share price of 1,236p.

JD Wetherspoon: Best case scenario for revenues and profits

Summary; Scenario 1A

	2019a	2020a	2021e	2022e	2023e
Total sales (£m)	1,819	1,262	879	1,819	1,910
Total sales growth	7%	-31%	-30%	107%	5%
EBITDA (£m)	219	86	13	204	229
PBT (£m)	103	-34	-112	81	102
Owners' earnings (£m)	100	14	-65	116	128
Net debt (£m)	737	817	969	874	763

The figures above are pre IFRS16 and exclude the benefit of the proposed equity placing. a = actual; e = estimated.

Source: JD Wetherspoon

The current worst case scenario has a slower profit recovery with 2019 levels not recovered until 2023. Free cash flow per share would be 59.8p in 2022 and 82.3p in 2023. This gives respective free cash flow yields of 4.8 per cent and 6.7 per cent.

JD Wetherspoon: Worse-case scenario for revenues and profits

Summary; Scenario 2A

	2019a	2020a	2021e	2022e	2023e
Total sales (£m)	1,819	1,262	722	1,637	1,819
Total sales growth	7%	-31%	-43%	127%	11%
EBITDA (£m)	219	86	-33	155	204
PBT (£m)	103	-34	-159	32	81
Owners' earnings (£m)	100	14	-111	77	106
Net debt (£m)	737	817	1,016	960	870

The figures above are pre IFRS16 and exclude the benefit of the proposed equity placing.
a = actual; e = estimated.

Source: JD Wetherspoon

Comparing these scenarios with current forecasts implies a big downgrade to 2021 with little change to 2022 and 2023 pre-tax profits on the best case scenario. Note that analysts' consensus forecasts for earnings before interest, tax, depreciation and amortisation (Ebitda) include depreciation from leases whereas the company's scenarios don't. This explains why analysts' Ebitda figures are larger.

JD Wetherspoon forecasts

Year(£m)	2021	2022	2023
Turnover	1,397.20	1,812.90	1,875.00
Ebitda	226.1	273.9	283.9
Ebit	87.1	132.6	154.6
Pre-tax profit	-20.1	86.1	103.7
Post-tax profit	19.4	74	82.3
EPS (p)	-13.9	59.4	69.9
Dividend (p)	3.9	8.2	8.4
Capex	57.4	67.7	71.2
Free cash flow	67.8	130.8	141.2
Net borrowing	965.5	839.1	723.9

Source: SharePad

I like the fact that Wetherspoon bases its owner earnings on maintenance capex. However, the problem with maintenance capex is that it only applies to some rather than all of a company's assets. Depreciation may not be the best estimate of stay in business capex, but at least it applies to all depreciating assets.

On the best outcome, you could make a case for the shares being attractive on a free cash flow yield basis, with the caveat I mention. An EPS of around 64p (on the higher number of shares in issue) in 2023 would put the shares on a current PE of 19.3 times. That looks high enough.

Sage

I continue to find **Sage's (SGE)** business performance to be disappointing. Its move to a subscription-based software as a service (SAAS) business is the right thing to do, but it has very little growth, while its main competitors are growing strongly.

It also continues to present a very confusing message to investors, in my view, by focusing on recurring revenue growth rather than total organic revenue growth. Recurring revenue growth is largely a result of customers switching from software licences to subscription rather than overall customer and revenue growth, which was only 1.4 per cent on an organic basis in Q1.

It's early days yet, but the company had previously said that it was sacrificing profit margins by up to 300 basis points in order to reinvest in marketing and drive growth. There is little evidence of early results here:

Sage: Q1 trading update

Organic[1] Revenue Mix	Q1 FY21	Q1 FY20	*Growth*	
	£m	£m	*£m*	*%*
Revenue by Category				
Recurring Revenue	£408m	£390m	*+£18m*	*+4.7%*
Other Revenue (SSRS[2] & Processing)	£39m	£51m	*-£12m*	*-24.0%*
Organic Total Revenue	£447m	£441m	*+£6m*	*+1.4%*
Portfolio View of Recurring Revenue				
Future Sage Business Cloud opportunity	£366m	£345m	*+£21m*	*+6.2%*
Non-Sage Business Cloud	£42m	£45m	*-£3m*	*-7.2%*
Recurring Revenue	£408m	£390m	*+£18m*	*+4.7%*

Source: Sage

Sage's performance needs to be compared with New Zealand company Xero. It grew revenues by 19 per cent in its half-year results, which included 19 per cent subscriber growth in the UK. US company Intuit is currently growing its Quickbook revenues at 12.9 per cent.

Sage forecasts

Year(£m)	2021	2022	2023
Turnover	1,860.30	1,943.70	2,052.50
Ebitda	411.5	450.3	482
Ebit	367.3	403	437.7
Pre-tax profit	352	386.4	417.6
Post-tax profit	253.9	282.6	312.7
EPS (p)	23.1	25.6	28.1
Dividend (p)	17.6	18.1	18.5
Capex	35.3	37.4	35.8
Free cash flow	260.7	311.7	329.8
Net borrowing	14.2	-99	-248.2

Source: SharePad

Sage is clearly losing market share with the only bright spot being the performance of the Sage Intacct financial and business management product sold in the US.

Current full-year guidance was maintained. At 601p, Sage shares trade on 26 times 2021F EPS, compared with Intuit on 46.6 times.

The more Sage's lacklustre performance continues, the more I see it as being vulnerable to a takeover. Its cloud-based approach and business management products could make a very good fit for someone like Microsoft which could buy Sage very easily.

Pets at Home

Pets at Home (PETS) continues to perform very well and proves that not all businesses sold by private equity firms turn out to be duds. To be fair, its fortunes only revived relatively recently with the post IPO performance fitting the classic private equity sell out quite well.

Pets are a very attractive investment theme which has become even stronger during lockdowns. The emotional attachment that people have with their pets means that they are happy to spend money on them. Pets at Home's retail and vets businesses are exploiting this trend very nicely right now.

Its third-quarter trading statement announced this week was very impressive. LFL sales in its retail business were up by 17.5 per cent and by 25.9 per cent on a two-year LFL basis.

This business has coped with the pandemic very well with its stores remaining open. Online sales and a one hour click and collect service have proven to be a hit with customers. Its subscription service – for things such as pet food – now has one million customers – up 17 per cent on a year ago – with £85m of annualised and recurring income.

I am impressed by what this business is doing. It has a big edge on supermarkets in terms of items such as pet food as it has a much better range and quality of product. If you care about what you feed your dog or cat then you will find the supermarket shelves stacked full of cheap grain-based food rather than predominantly meat products. Pets at Home faces strong competition online from the likes of Zooplus and Amazon (which has launched its own premium pet food range), but it looks to be more than holding its own.

The vets business is also performing extremely well and has been adding 10,000 new customer registrations per week for the last six months. LFL sales were up by 17.8 per cent in the third quarter.

Pets at Home forecasts

Year (£m)	2021	2022	2023
Turnover	1,101.30	1,159.90	1,216.30
Ebitda	209.5	236.5	246.7
Ebit	96.7	118.9	126.6
Pre-tax profit	81.2	107	118.7
Post-tax profit	62.9	84.4	92.1
EPS (p)	12.6	16.9	18.8
Dividend (p)	7.4	8.4	9.3
Capex	41.5	55	55
Free cash flow	78.3	86.2	95.3
Net borrowing	25.9	-9.1	-103.7

Source: SharePad

Pre-tax profits of at least £77m are expected for the year to March 2021, while 2022 forecasts are already assuming a big recovery. The current strong trading bodes well though, and is backed by some tangible business initiatives that are clearly bearing fruit. There's a lot to like about what's going on here. At 412p, the shares trade on a March 2022f PE of 24.4 times. I'm inclined to think that could still represent reasonable long-term value in a low interest rate world.

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ISSN 0261-3115.