Investors' Chronicle | Alpha

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Alpha weekly shares analysis

25 June 2021

Can these shares maintain their momentum?

Last week's AlphaScreen which highlights shares based on share price and earnings upgrade momentum identified, as you would expect, several companies that have become darlings of the stock market over the past 12 months. Analyst Robin Hardy runs the rule over a few of them, to assess whether the stories and fundamentals do suggest scope for further gains.

Making a call on whether to expect continued earnings upgrades:

- **Watches of Switzerland Group (WOSG)** has shown that luxury retail businesses can be resilient, even in a pandemic. Strong underlying growth and expansion plans help counter claims this is just a glamour stock.

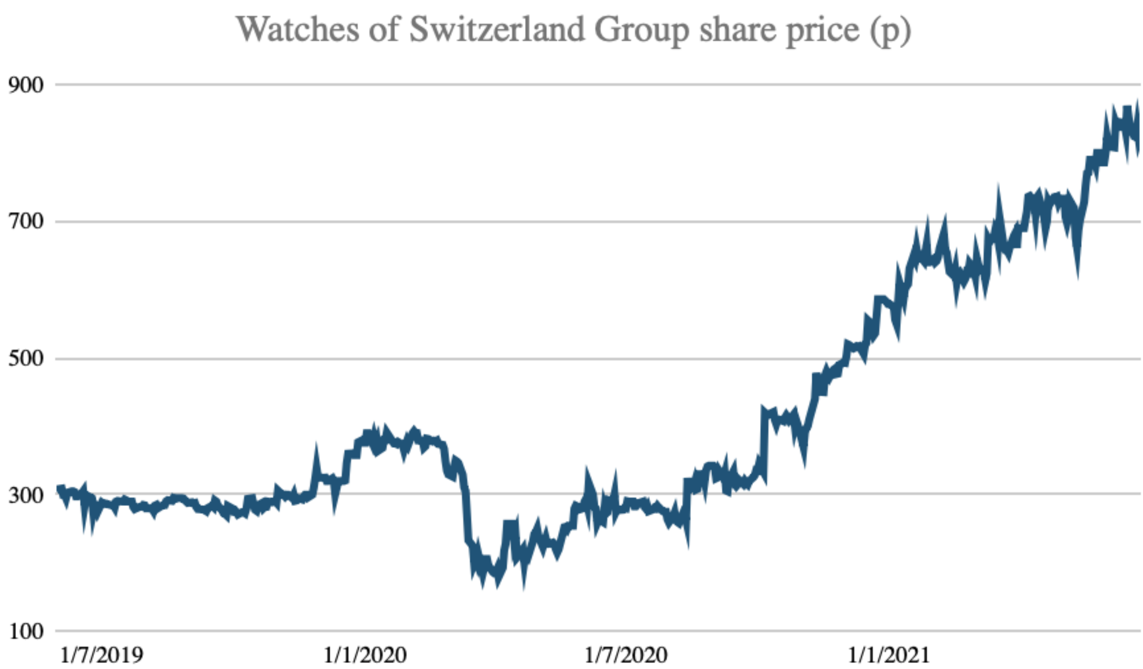
- Equipment hire business **Ashtead (AHT)** has attracted enormous interest thanks to its North American focus and the enormous boost expected from President Biden's US infrastructure plans. The question is: is all the good news priced in and will some investors switch to harvesting some of their gains?

- Publisher **Future (FUTR)** initially surprised markets with its acquisition of price comparison website Go Compare but improved sentiment towards the deal and the continued success of Future's innovations to expand digital revenues have seen the share price perform strongly. Much will depend on how Go Compare is integrated and how the continued structural shift to online advertising are managed.

Analyst:

Robin Hardy

Watches of Switzerland – about time



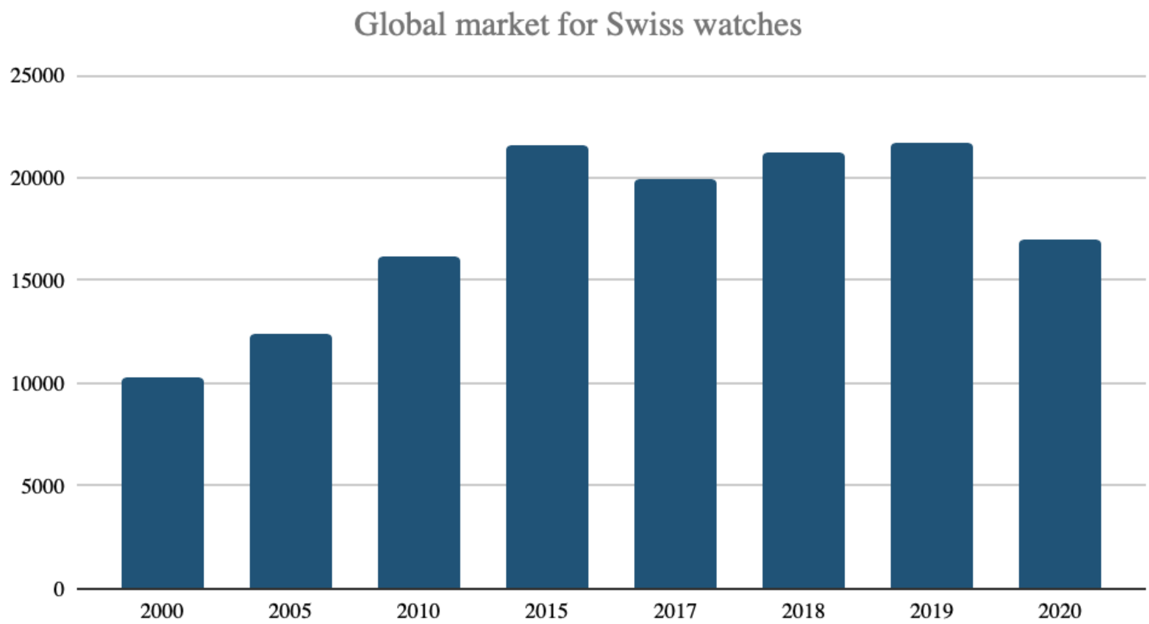
Source: FactSet

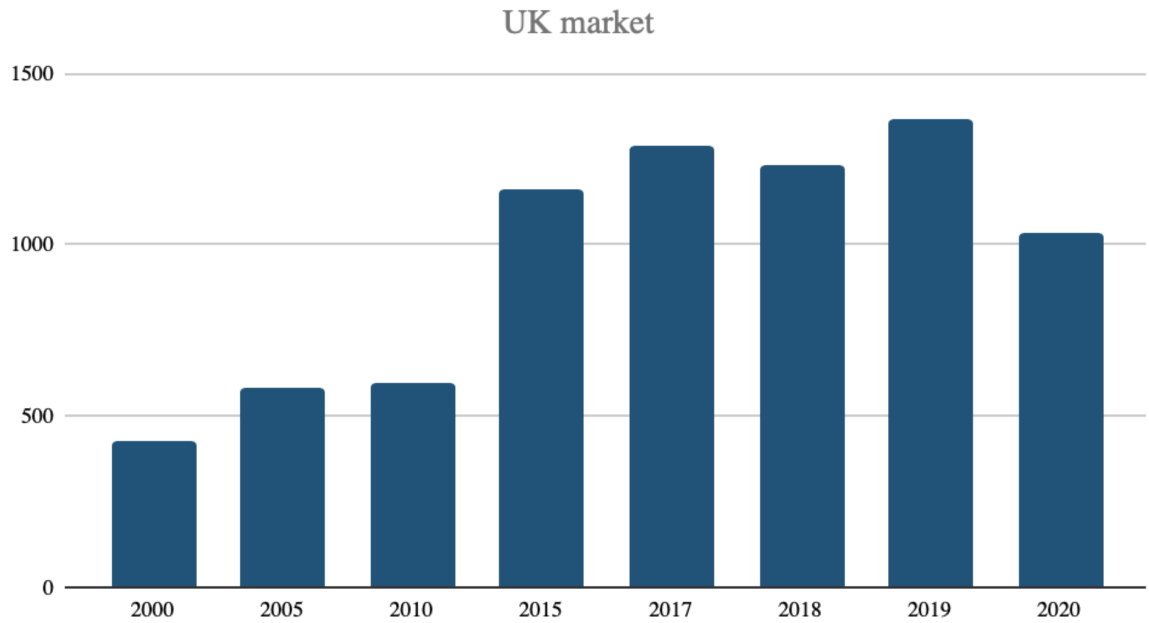
An external observer's first impression of the luxury goods market might be to think that when times become uncertain, more expensive purchases are the first to be cut – this would include expensive Swiss and other premium watches.

However, the luxury goods market does not seem to follow the rules of others and suffered much less of a hit during the Covid-19 crisis than many other industries in 2020. According to the Federation of the Swiss Watch Industry, shipments by value fell c.22 per cent versus 2019, but demand for its products (evidenced by order books and waiting lists) was almost unaffected; and in some markets it appeared to increase.

Prices also seem to have increased. Long-term analysis of this market suggests that growth has remained very stable, averaging 4 per cent per annum across the past 20 years.

Chart 1: Shipments of Swiss Watches in CHF million





Source: Federation of the Swiss Watch Industry

Watches of Switzerland (WOSG) operates in this market as the UK's leading retailer of luxury watches (which account for c.87 per cent of its forecast £1bn of global sales in FY2022). A long established player in the luxury jewelry market, WOS is now driving for a similar position in the much larger US market (which is some 90 per cent bigger than the UK) springing from its entry here two years ago by acquisition.

Despite only having its shops open in the UK for 42 per cent of the total potential opening hours in the past financial year, revenues rose by 3.6 per cent, with strong exit momentum: in Q4 sales were rising by almost 50 per cent year on year. Being less aggressively shut down, the US was able to trade for 77 per cent of the total potential hours enabling revenues to grow there by almost one third. All of this was achieved despite the collapse of the international traveller business, which dropped from around one-third of sales to only 7.5 per cent. That underscores the strength of domestic, local sales.

How has WOS managed to achieve such a creditable performance against what were pretty stiff headwinds?

1. **Strong underlying demand** – watch buyers are prepared to defer their purchases and many look to have returned to the market as soon as their local store opened. Unlike pubs or restaurants where sales, when closed, are lost forever, the luxury market builds up and holds on to demand. If a buyer really wants a premium watch for a 50th birthday they will defer that purchase. There has always been a culture of buyers prepared to sit on waiting lists in this market. There are also watch collectors and investors who are prepared to play a long game.

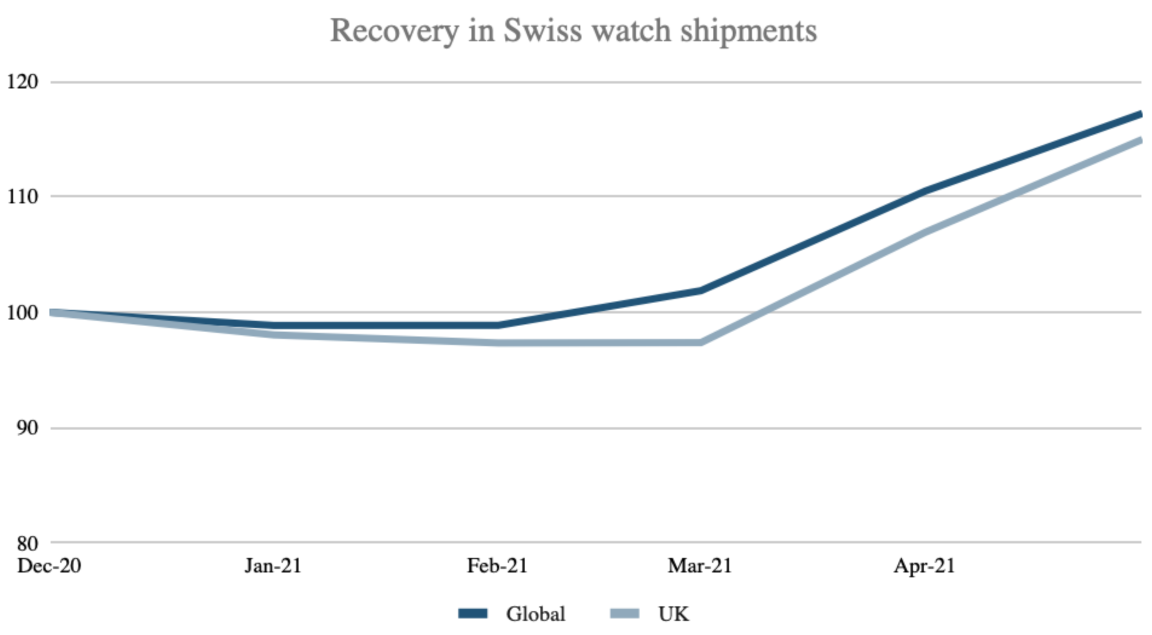
2. **Online sales** – while still very small (only 5-7 per cent of sales) internet transactions for WOS rose > 200 per cent in FY2021. Buying such expensive goods (the cheapest Rolex watch costs c.$5,000 or equivalent) has meant that most sales will still take place in store, but WOS has made good use of social media and online advertising (often hand-in-hand with watch manufacturers) to build demand that has translated into store sales. Online sales also helped boost margins, which rose over 200 basis points in the past year.

3. **US expansion** – WOS believes that while the US is a larger market by value than the UK, it is less well developed (only double market value versus 5x the population) and feels that watch manufacturers will be keen to support its brand as it seeks to grab market share from local and small chain jewelry retailers.

4. **Monobrand stores** – the opening of more single-brand focused or 'monobrand' stores is a key part of WOS's growth strategy. These stores present as if the brand itself is selling on the high street and have proved to be a strong driver of sales. Typically much smaller than a generalist store, these outlets help to grow margins, which for the group are still fairly low for a luxury retailer. Although climbing from c.7 to over 10 per cent in the latest half-year results, there does appear to be headroom to grow returns.

WOS has shown that even in straitened times it can grow, partly through a very robust underlying market, but also by well-focused self- help. Revenue is guided to 11 per cent growth in the year just ended (May 2021) and by a further 18 per cent in the current year, with both years showing slightly improved margins. This has been achieved without the rebuilding of tourist business in the UK or US. This performance, with growth achieved well ahead of a wider retail sector recovery, does indicate that WOS has the credentials of a sustainable growth stock.

Chart 2: Recovery in Swiss Watch shipments – Jan 2021 = 100



Source: Federation of the Swiss Watch Industry

The share price recovery from the initial 50 per cent slump in Q1 2020 has been substantial with a near five-fold increase to date, which leaves the shares trading on a year 2 PE ratio of around 30 times.

WOS is establishing that it is a business with very robust drivers and no small measure of effective self-help able to deliver comfortably double-digit earnings growth. It is now a £2bn market capitalisation business well-established in the FTSE250 index, meaning that this is a stock fund managers can no longer ignore.

Early in the pandemic it could have been dismissed as risky and worthy of a de-rating out of fear of consumers retrenching. Its early recovery could have been viewed as just unrepeatable sales catch-up, but that view is now harder to square.

The rating is high, but not excessive given the growth rate (average PE for FTSE 350 is 19), but after a re-rating on the back of proving market scepticism to be ill-placed, it is hard to see that rating pushing much higher.

WOS may appear to some still to be a fad or glamour stock, but it does have solid fundamentals and a clear, coherent growth strategy. Is it capable of continuing to storm ahead like Fevertree, which even now commands a P/E of 60 times? Probably not, but there is nothing visible (not now that it has shown that even aggressive lockdowns and very restricted store opening hours are not a barrier to trading) that is likely to cause a de-rating either. There are no major sell signals here, but to drive the valuation up there will need to be a fairly material upgrade cycle – that feels some months away yet.

Even without that, the shares will most likely be able to track the rate of EPS growth over the next couple of years, so investors could still expect to see double-digit returns. While there is no rush to chase the shares up, there may not be many opportunities to pick up stock on the cheap either.

Ashtead – a leopard changing its spots

Source: FactSet

Ashtead (AHT), the primarily North American-based equipment hire business (86 per cent of group revenues compared with 12 per cent, and falling, from the UK), staged a spectacular share price performance in 2020 leaving it as the FTSE100's top performing stock.

Ashtead entered 2020 with a share price that had already doubled in the preceding five years, riding the wave of extended economic positivity through both the Obama and Trump administrations. The first Covid-19 lockdown knocked the share price hard, but it had fully recovered by the first week of July before coming close to doubling again through to recent highs – all told, a four-fold increase from the trough to the peak. So what caused such a spectacular run and acceleration in its performance?

There has been a lot of talk about President Biden's $2 trillion infrastructure plans being a key driver, but this has only arisen the past few weeks, although it or something similar was clearly anticipated. Also the shares' momentum did not change in either November, when a likely higher spending president was elected, or in March when the infrastructure plan was finally unveiled. Indeed, the shares have actually lost forward momentum most recently, peaking at the end of May.

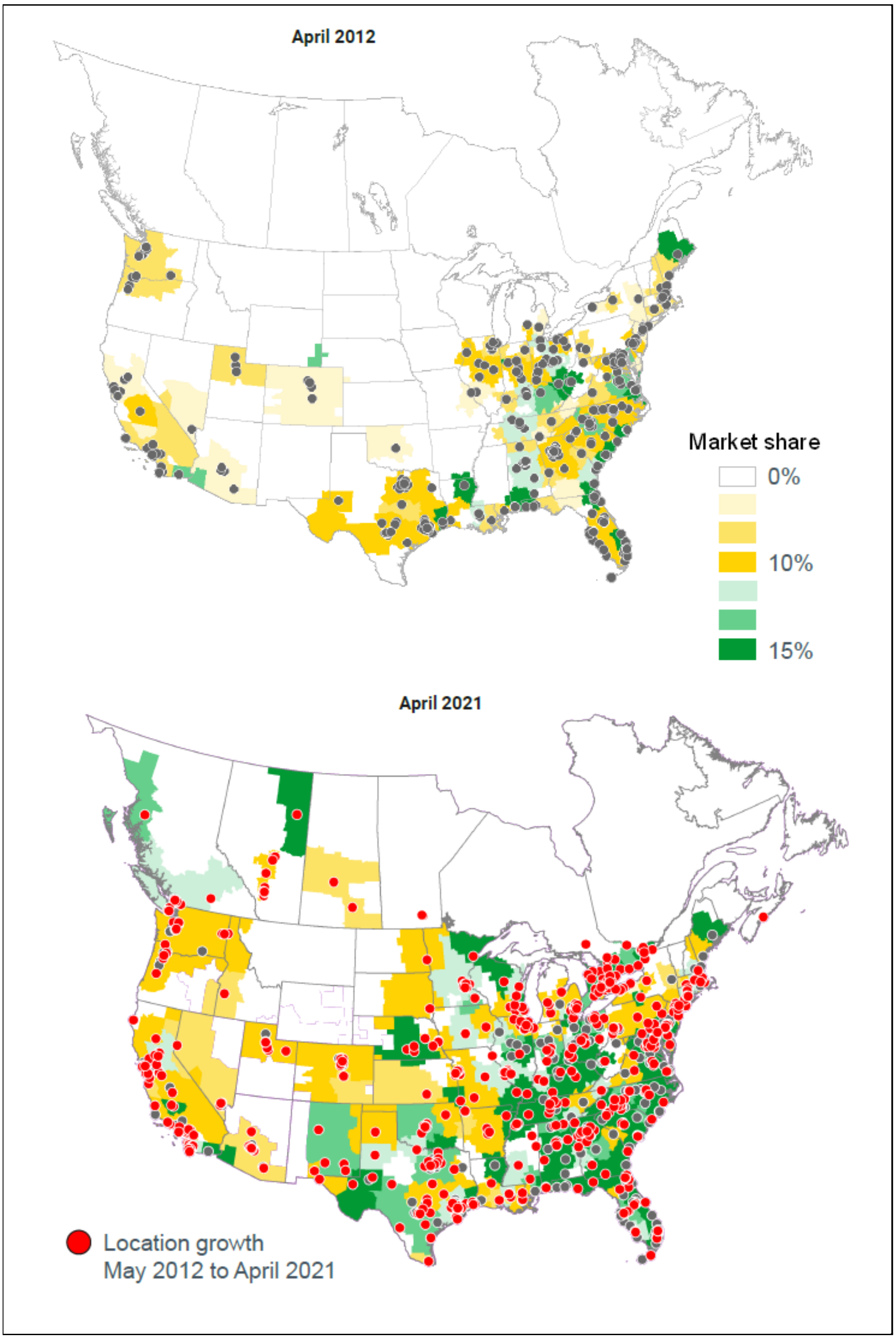
US core infrastructure is acutely and chronically under-invested in and is going to play a role in sustaining the above trend outlook for US construction activity in the next three to five years. But while this tick up in Ashtead's core markets (growth might hit 7-9 per cent against 3-5 per cent average since 2012) is helpful, it is not enough to have driven the scale of share price re-rating we have seen here. Also infrastructure spend in the US is more typically 'heavy' (i.e. civil engineering for roads) and is of more benefit to basic materials businesses such as CRH.

Ahstead's growth has long been driven by expansion and there is a strong record of smart, substantial expansion and diversification (by geography, product type and industry served) taking best advantage of a still highly fragmented equipment hire market.

As Chart 1 shows, Ashtead has grown substantially since 2012, but notably still does not hold a market share of more than 15 per cent in any local market, highlighting the continued fragmentation. US market leader is United Rentals at 14 per cent share, then Ashtead with 10, Herc with 3 per cent and then a very long tail.

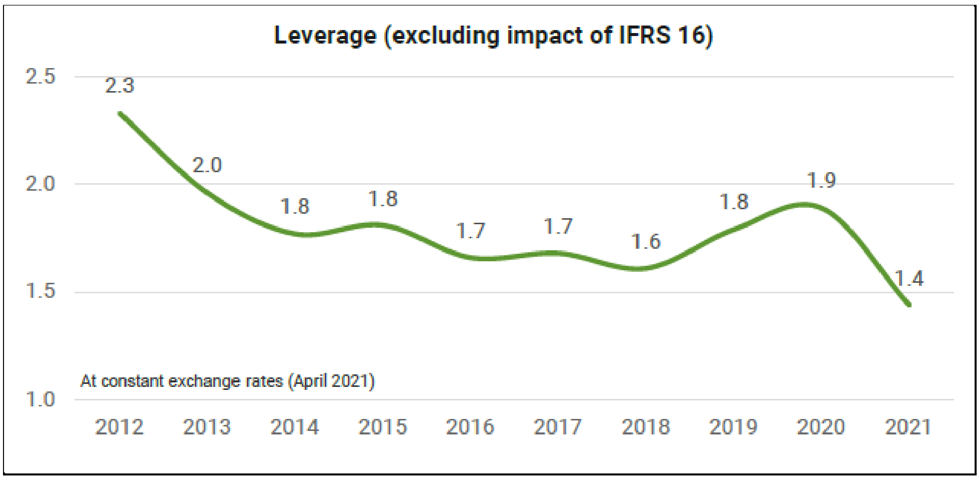
In this period, earnings before interest, tax, depreciation and amortisation (Ebitda) has grown from £380m to £2.3bn; £2.4bn has been spent on acquisitions, £5.1bn on growth capital expenditure; some £1.2bn of share buy-backs have been made but at the same time gearing has dropped (see chart 2).

Chart 1: Ashtead's US expansion



Source: Ashtead

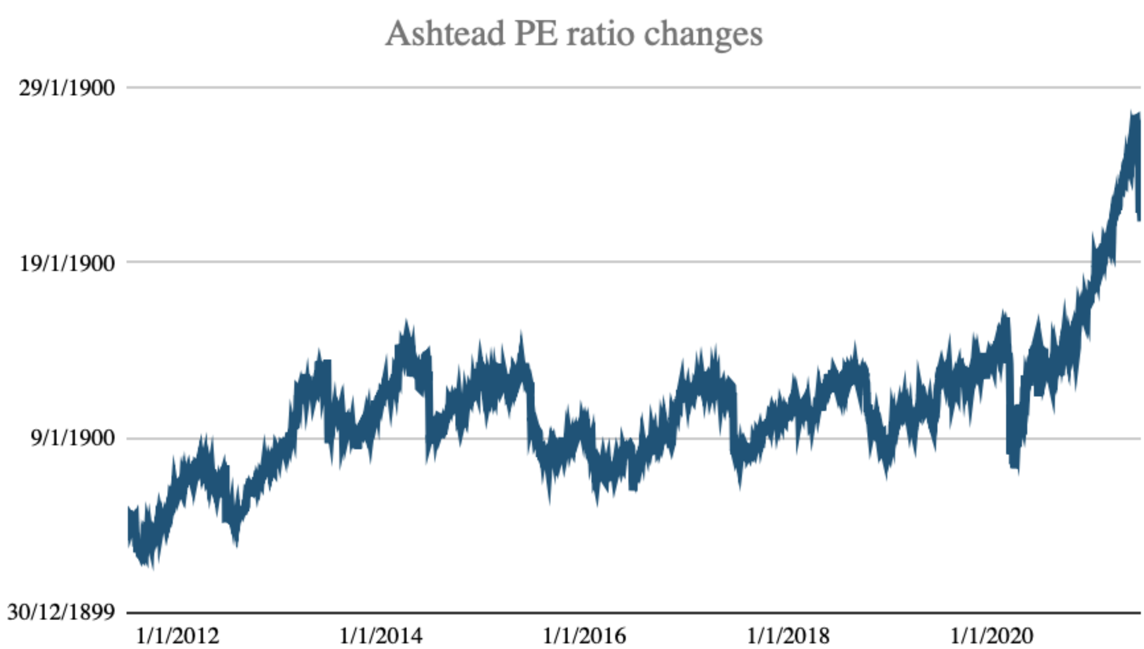
Chart 2: Ashtead's gearing – net debt to Ebitda



Source: Ashtead

Unquestionably, Ashtead has exhibited an impressive rate of growth, partly thanks to supportive markets, but mainly by its own hand, yet the rating (in terms of the PE ratio) was stuck in a rut. In chart 3 below, we can see that PE ratio based on earnings forecast two years ahead was stubbornly stuck in the low-to-mid teens and never exhibited the breakout that occurred in 2020, despite continued high growth.

Chart 3: Ashtead's year 2 PE ratio



Source: FactSet and Investors' Chronicle

The reason was that despite posting impressive increases in earnings, Ashtead was still seen as a riskier cyclical stock benefiting from an extended economic cycle that the market feared would end, eventually, the same way it did after the 2007 financial crisis. Equipment hire operators then descended into a price war to try to sustain sales – price cuts in this sector erode margins at an exceptionally high rate due to higher fixed and heavy depreciation costs.

Despite Ashtead's management long preaching that the industry was more disciplined and that in a downturn it could largely sustain its business and begin to show very high free cash flow by halting investment, there was limited faith among investors. As the first lockdown came, the market dropped by 35 per cent, but Ashtead fell by closer to 60 per cent out of concern of a re-run of the last downturn.

Within just a few weeks, however, it became clear that Ashtead was right. There was no price war and business levels dipped, but by modest single-digit percentages, and began to recover quickly. And the group was beginning to throw off cash by stopping investment, while holding steady on profitability. This was the driver of the re-rating.

Ashtead was suddenly showing that it was no longer a riskier cyclical business, but rather a structural growth stock whose record began to be re-evaluated. The view re-formed that the growth delivered over the preceding 10 years was a lot more to do with the group's own actions than it was a reflection of buoyant underlying markets.

Ashtead was now on the radar of many more institutional investors who could no longer ignore a large FTSE100 stock that increasingly looked as if it was rated on the wrong basis. The shares did not see an overnight re-rating as there was still some incredulity to be overcome, but quarter by quarter Ashtead was able to show that the conversion from a cyclical was real, prolonging the re-rating process.

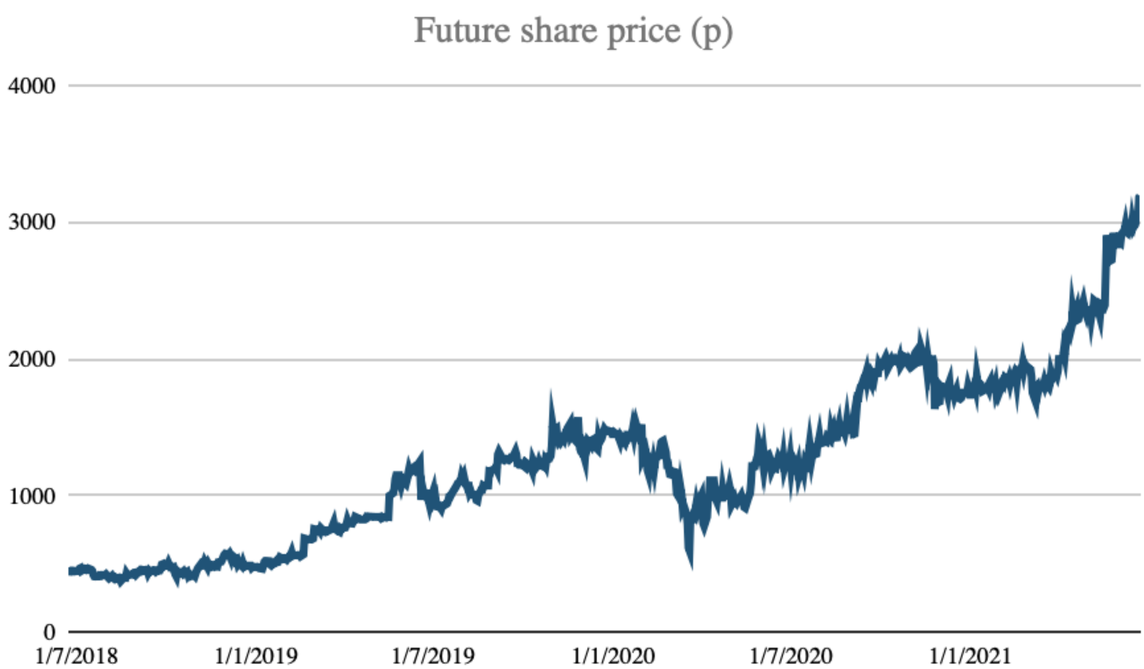
Where next for the momentum in the share price? Essentially the task of re-rating a stock is a once only, step change albeit in this case it was an extended step. The newly acquired, higher rating is likely to stick but it is hard to see that anything like the increase in the last 12 months will be repeated. Ashtead still has to prove that it justifies its new classification as a growth stock and that will have to be shown across at least another full year of trading. The weight of money chasing the stock is likely to have subsided as most funds managers that wish to will have reweighted their holdings and there will be many other investors wanting to harvest at least some of the past year's gains.

All told, the shares are more likely to move sideways or slightly down although there is scope for share buy-backs (already recommenced) and stand-out acquisitions to drive an earnings upgrade cycle. However, nothing is likely until at least the Q1 trading update in early September and even then the scale of any changes to forecasts would be expected only to fall in line with the existing guidance on growth. This means that the shares are unlikely to continue to feature among the market leaders.

Should investors sell? Probably not but there will be better times to pick-up stock in the next few months. Although the stock has re-rated in a step-change, its share price over the longer term has tended to track EPS growth. If the board can deliver on its promise of 15 per cent compound growth through to 2024, that feels as if it could be the overall return that investors can expect to achieve here, better than most investors would be targeting.

As an afterthought, it is notable that Ashtead has just changed its reporting currency from pounds to US dollars. This might just be alignment of where revenues arise or Ashtead could be preparing to follow the lead of Ferguson, shedding the UK operations and relisting in the US. This could boost the rating and allow Ashtead to take on more debt without doing harm to its valuation and accelerate growth: US markets are a lot more tolerant of debt than the UK. Such a step could trigger a fresh re-rating.

Future – new model media



Source: FactSet

Who would want to invest in a business selling magazines? Newsstand sales and subscriber numbers are falling across the industry and advertisers are looking to place budgets in areas that offer the best return – online or social media. **Future (FUTR)** is a content owner and publisher but somehow is expanding rapidly, producing sharply improving earnings that allowed its shares to outperform the All-Share Index by 116 per cent over 12 months.

Part of that strength is that the near 60 per cent slump at the start of the first lock down should arguably not have been so deep. Future's portfolio is focused on hobbies and interests and the types of projects people spend their days doing during their time at home. The rebound was rapid with the pre-Covid-19 share price largely regained in about 10 weeks as evidence of rising page impressions and no panic withdrawal by advertisers emerged.

What is Future doing to drive growth out of an ostensibly dying market in print media? In essence, Future takes existing magazine titles or 'brands' and extracts online advertising and other revenues from the readership. Nothing special here but Future has the ability to extract more than one might expect from its portfolio using what it calls its 'platform'.

This is a mechanism generating basic online advertising revenue, offline adverts (e-mailshots) and, what is unique to this model, provide feed-through commissions from products, services and events that are profiled in the online publications. The latter is now the largest single block of group revenue and is growing at 56 per cent organic and 116 per cent, including acquisitions. These operations generate a gross margin of 85 per cent and are what propels the whole entity forwards at its rapid pace.

The big question here has to be the sustainability of the model. One imagines that there is a limit to the income to be extracted from each title and, although that point is probably not yet reached, maturity is likely to be fairly rapid.

They could push titles into new markets (the US is relatively immature as are other English speaking markets such as the Far East), but does Future need constantly to add new titles by buying portfolios such as it did with TI Media in 2019? Not today, but in time it will and there must be a diminishing pool of fresh, quality titles available (or available at viable prices) to feed the platform.

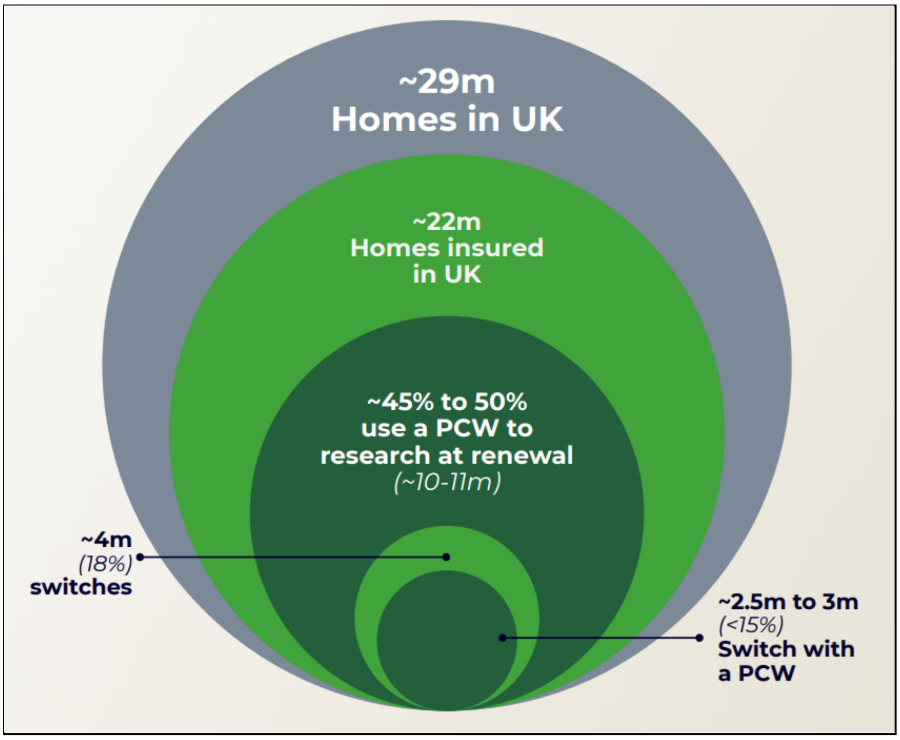
There is scope to diversify into foreign language titles, but this is not on the radar. Diversification is always a riskier path, but Future has already made one large seemingly sideways step: the purchase of Go Compare in November 2020.

This acquisition shocked the market and the shares dropped 15 per cent on the news. It was a pricey deal at c.£600m and did not seem to fit, sparking fears that the existing model was running out of road. Future is confident that there is a high marriage value here, plugging the price comparison websites (PCW) into its network of users in much the same way as it does with a print magazine title.

A number of the group's titles already compare and rank products and services pertinent to particular publications and provide pass throughs to providers, something that the PCW skillset could enhance. Using PCW's technology, readers could set their own criteria to help rank and choose their ideal new bicycle, camera or golf course. 'Top 10' lists in titles have been largely static hitherto, but making those lists personal and dynamic could create new revenues.

Also using its proven skills to increase customer reach and penetration, Future hopes it can improve conversion rates within existing PCW searches: today only 40 per cent of car insurance and 20-25 per cent of home insurance policies are switched using the PCW channel directly (where fees or commissions are made). Too many site visitors to Go Compare just do research, meaning little or no revenue generation. Broadening the base from Home and Car insurance to other areas such as broadband, energy and financial products is possible, but this could cause a fight with the likes of MoneySupermarket.

Chart 1: Low conversion from price comparison websites



Source: Future plc

And what of print titles and the seemingly terminal decline of that segment? To grow the online platform, more print titles have to be acquired: the purchase of TI Media in 2019 caused print revenues to triple in FY2021. This does mean that a larger portion of the group's revenues are in reverse organically and this could begin to drag on growth rates. This business is still profitable but the clock is ticking.

So there certainly seems to be plenty left in the investment story in the medium term, but where now for the share price? Much of the recent strength of the shares has been due to a re-rating as proof of concept of the unique business model has shown through driving an upgrade cycle. However, that can only be pulled off once. Now the model is understood by the market and is more proven, it has far less scope to surprise – the positives are already in the price.

The combination with Go Compare should deliver fresh growth, meaning the upgrade cycle is not over as most forecasts appear to factor in little more than a straight bolt-on of Go Compare plus some modest synergies. The bigger potential kick from marriage value is still to be proven and is likely to take at least a year to show.

While the 25x P/E to September 2022F does not look especially high (market average 19x), the consensus estimate for growth into 2023 is just 9 per cent and does need a fresh upgrade cycle to sustain it at current levels. The market has become used to sizable upgrades here, most recently by 15 per cent following the half-year results.

The market still seems minded to trust that Future's model will deliver and that the upgrades will come through for the next couple of years before some of the issues we map out above perhaps begin to drag on the rate of growth. Meantime, the shares feel more like to drift than to sustain their previous momentum.

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ISSN 0261-3115.