Investors' Chronicle | Alpha

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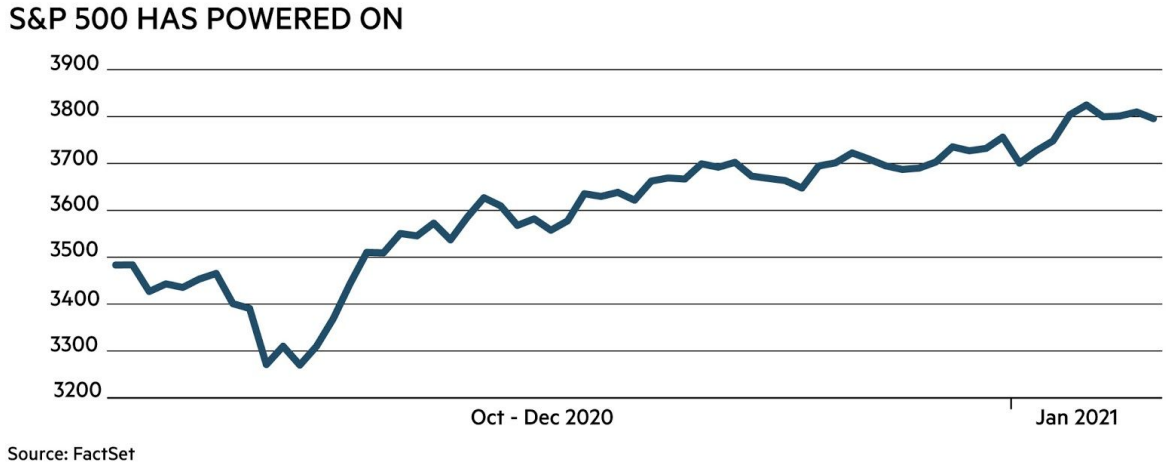
The current state of investing

15 January 2021

There is a lot of talk about frothy share valuations

Chasing stories rather than looking at cash flows and fundamentals has become a trend amongst many private investors and some fund managers. The key difference between amateur punters and the best fund houses, however, is that the latter take time to understand the business models of companies and the end markets they sell into. That's an example some people rushing into stocks on apps like Robinhood should heed.

Report by Phil Oakley



There is a lot of talk of how frothy share valuations are right now.

I agree, there are lots of examples of speculative excess. Perhaps one of the best examples came last week when Tesla founder Elon Musk – associated with one of the frothiest shares out there – advised his followers on Twitter to dump Facebook's WhatsApp messaging service over privacy concerns and use Signal instead.

The shares of Signal Advance, which lost $125m in 2019 literally exploded and went from a price of 58 cents to just over $38, no doubt netting small fortunes for those who got in early.

This symbolises the current trend of chasing stories rather than established businesses with meaningful profits and cash flows. Yet, it is not just private investors with their keyboards and mobile phones that are employing this kind of strategy, some of the best performing fund managers are doing similar things.

I have a huge amount of respect for Baillie Gifford and think it is one of the best investment businesses in the UK and I currently have investments in several of its investment trusts. It makes no secret of the fact that it does not invest like many of its peers do.

Over the Christmas period, I spent several quiet hours reading the annual reports of its investment trusts. The common theme of its investing strategy is well known to people who have invested with it for years. It believes that the really big investment returns come from just a few rare, outstanding businesses and it spends all its time trying to find the businesses that will do this.

The key difference between Baillie Gifford and amateur punters on Robinhood is that it spends huge amounts of time understanding company business models and end markets before it invests its customers' money. This is the key part of its risk control and all investors would do well to follow this approach.

It freely admits that many of its investments will not pay off, but many of them have in recent years and if enough of them do its investors will do well.

However, I think it's important to try and understand why some of those investments have done well. Is it because of business performance or the luck of being exposed to an area where animal spirits are high or even excessive?

If we take the case of Tesla which accounted for a considerable chunk of Scottish Mortgage Trust's stellar returns last year, there is no way that the 743 per cent total return from the shares was warranted by its business performance. The company has a current market capitalisation of $801bn and is expected to make a net income of $6.8bn in 2022, putting it on a PE of 118 times.

SMT's managers have been dismissive of valuation metrics and there's no doubt that ignoring the fact that Tesla is worth more than a large chunk of the combined global car industry combined has worked out well. But when does valuation matter?

If valuation does not matter any more then are the likes of SMT investors, or just incredibly diligent and successful speculators that have had a large slice of luck?

What troubles me is that there has been for some time a clear divergence between business returns as measured by revenues, profits and free cash flows (that an outright owner would receive) and the returns dished up by the stock market. This is what happened in the dot-com bubble and it did not end well.

None of us can predict the future with any great deal of accuracy, but I do accept it is possible to identify businesses and technologies that have the potential to spur radical changes in markets and become very successful. The likes of SMT are increasingly investing in unquoted private companies to do this and have been for a while.

This is something that is very difficult for most private investors to do directly. It is also very difficult to know whether your investment will work out and that you are paying the right price. Success is therefore dependent on taking lots of risk and hoping for some degree of luck that your due diligence is on the money.

This for me is the edge that Baillie Gifford offers its investors. In a world where thousands of analysts and fund managers are all looking at the same pool of shares, it's very difficult to get an information edge in big mega-cap shares. But you can get an edge in unquoted businesses.

Which leads me nicely to the other investing approach that has done well since the financial crisis – quality investing in big established businesses. Arguably the best exponent of this approach has been Terry Smith with his FundSmith investment fund. His simple approach is based on buying good companies, doing nothing and not overpaying for them.

I think Mr Smith is a very diligent and highly competent analyst, but I very much doubt that he has a huge informational edge in many of the shares in his portfolio. But it doesn't seem to have mattered regardless. That said, he does read annual reports which most people don't bother with so I am prepared to admit I could be wrong here.

The not overpaying part of his strategy has intrigued me for some time. How much does Mr Smith think is enough or a reasonable entry price for a share of an outstanding business?

Based on two of his most recent new investments in the past year or so in the forms of Brown Forman and LVMH, my guess is that the answer is around 3 per cent. This is what I think the approximate earnings or free cash flow yield he paid to buy these shares was, but I don't know for sure.

This is a high starting price, but it is currently higher than the yield on government bonds and the rate of inflation. If both continue to stay low and the companies deliver mid- to high-single-digit percentage EPS and free cash flow growth over many years, then it is possible for these investments to be very successful. There can be no doubt that Mr Smith has been brilliant at executing this strategy.

It is one that I pretty much subscribe to myself. I have not done as well as him, but over the three and a bit years or so my Fantasy Sipp is not too far behind, although I have done less well recently.

This goes to prove that investing is not easy.

There is no doubt that many investors – including myself – are currently holding portfolios of very expensively-valued shares. I think interest rates will stay low, but inflation is more difficult to call. Commodity prices are showing signs of life and these need to be closely watched.

Commodity prices

Commodity prices % change	Price	1 month	Year to date	1 year
Brent Oil $	5577.75	10.7	7.8	-13.5
Coal	7025	7.33	1.44	34.6
Copper	361.7	2.57	2.78	25.9
Iron Ore	13403	-11.3	-15.3	41.7
Palm Oil (Crude)	86600	9.41	5.38	20.3
Soybean	140625	19.7	7.27	49.2
Sugar	15.84	12.2	2.26	10.6
Wheat	62575	11.3	3.69	25.9

Source: SharePad

If inflation jumps – perhaps due to capacity constraints that can't cope with recovering demand – and that jump is more than a blip, then share prices (particularly of highly valued shares) are going to be very vulnerable to a sharp correction.

I have my eyes open with this risk and am still not prepared to sacrifice business quality for cheapness. Time will tell whether this turns out to be a bad decision.

UK Quality Shares Portfolio versus Benchmarks and Comparator Funds year to date

Portfolio % returns	1 month	Year to date	1 year	2 years	3 years
Vanguard FTSE 100 ETF	3.1	4.2	-9.2	4.9	-2.7
FTSE All-Share – Total Return	3.6	3.6	-7.2	7.8	-0.3
Vanguard FTSE 250 UCITS ETF	5.4	0.8	-3.7	15.8	5.4
Baillie Gifford UK Growth Trust	9.9	0.7	15.3	35.8	30.4
Castlefield CFP SDL UK Buffettology	3.2	-0.5	0.9	24.7	28.7
Phil Oakley UK Quality Shares	**3.4**	**-0.5**	**-2.6**		
Finsbury Growth & Income Trust	0.5	-0.6	0.1	17.0	20.5

Source: SharePad

Fantasy Sipp vs Benchmarks and Comparator Funds year to date

Portfolio % returns	1 month	Year to date	1 year	2 years	3 years
Mid Wynd International Inv Trust	4.7	3.5	22.1	60.5	49.5
Martin Currie Global Portfolio Trust	5.2	1.5	21.0	61.6	56.8
iShares MSCI World Acc	1.0	1.5	10.5	36.1	32.2
Vanguard S&P 500 ETF	0.6	1.3	11.5	41.9	43.0
Lindsell Train Investment Trust	10.8	0.9	26.3	25.4	81.1
iShares NASDAQ 100 UCITS ETF	1.2	-0.2	35.8	85.3	93.8
Scottish Mortgage Investment Trust	5.2	-0.7	101.0	153.0	160.0
Fundsmith Equity T Acc	2.6	-1.7	16.4	48.1	52.2
Phil Oakley Fantasy Sipp	**-0.3**	**-1.8**	**6.8**	**40.2**	**46.0**
Smithson Investment Trust	3.0	-2.1	26.1	63.3	
LF Blue Whale Growth	3.1	-2.8	21.6	56.3	71.1

Source: SharePad

Games Workshop

Games Workshop (GAW) continues to demonstrate that it is a great British success story with another strong trading performance.

Its half-year results were pretty well flagged in a trading update at the beginning of last month. Strong sales growth of 26 per cent to £186m translated into a pre-tax profit growth of 56.3 per cent to £91.6m, which coincided pretty well with guidance of "not less than £90m".

Games Workshop remains a great example of strong management and great customer engagement, combined with a highly operationally geared business model, which shone through in these results.

The additional revenue was delivered on a lower cost base once an admirable payment of a discretionary £5m bonus to staff is taken into account. This was achieved with good cost control and the benefits of selling through trade and online channels where costs are lower. Gross profit margins increased from 69 per cent to a very impressive 75 per cent.

The growth and demand for Warhammer products has continued unabated, despite lockdowns across the world. The company's chief issue at the moment has been keeping up with demand as evidenced by a greater number of products being out of stock and references to its Memphis distribution facility in the US being "stretched to its limits" during the peak December selling period.

The step change in demand for Warhammer 40,000 products and the continued strength of the Age of Sigmar range saw the Nottingham factory increase its output by more than 30 per cent compared with a year ago. This helps you understand why profits have

increased by so much, as the operating leverage effects combined with high gross margin products on the large fixed cost base came into play.

The new second factory in Nottingham is not far off being ready and some extra land next to it has been bought. The Memphis facility expansion should also be ready this year, while improvements have been made to logistics and warehousing with component supplies being brought in house. In short, the company has the capacity coming on stream to help it grow further in the years ahead.

Customer engagement is probably the main reason why I like and admire this business. I see the launch of warhammer-community.com back in 2016 as a pivotal point in the company's development, which has contributed so much to its current and ongoing success. Visitors to the site increased to 4.9m in the six months to the end of November from 4.7m in the same period last year.

There are still some easy wins to be had in this area with customers being moved across to My Warhammer and some improvements made in site navigability and personalised recommendations.

The share price did not react well to the results. I fully understand why, but it does not concern me. The lack of profit guidance for the full year to May combined with the comment that December sales were "broadly in line" with the Board's expectations rather than ahead will have spooked some investors.

While predicting the future with any business can be difficult, the strength of sales during the past eight months has put management in a difficult position. That said, I don't think it was unreasonable for them to give a very conservative estimate of profit guidance.

The company has plenty of new product releases in the pipeline to keep customers happy, while lockdowns should see the company keep the cost and gross margin benefits that come from online and trade sales for a while yet, along with some positive leverage effects. The other key point to bear in mind is that the factory and stores were shut down for six weeks in the final quarter of the year to May 2020, which gives a very soft comparative to be well exceeded.

Forecasts from City brokers are largely ignored by those that follow this company closely. Very few expect the company to make £140m of operating profit, which is the kind of number that many analysts were going for before the results were published. This implies a collapse in operating margins back to the levels seen in 2019. This could happen, but I think it is very unlikely.

Games Workshop. Historic Profits and Forecasts

£m	2019	Q1 20	Q2 20	H2 20	FY 20	Q1 21	Q2 21	H1 21	LTM	H2 21F	2021F	2022F
Revenues	256.6	78	70.4	121.3	269.7	90	96.8	186.8	308.1	162.3	349.1	381.2
op profit	69.9	28	20.5	24.7	73.2	45	38.3	83.3	108	44.6	127.9	141.6
Royalties	11.3	2	8.7	6.1	16.8	3	5.7	8.7	14.8	4.3	13	15.4
Tot Op Profit	81.2	30	29.2	30.8	90	48	44	92	122.8	48.9	140.9	157
Margin	27.2%	35.9%	29.1%	20.4%	27.1%	50.0%	39.6%	44.6%	35.1%	27.5%	36.6%	37.1%
Margin incl Royalties	31.6%	38.5%	41.5%	25.4%	33.4%	53.3%	45.5%	49.3%	39.9%	30.1%	40.4%	41.2%

Source:Company Reports/Edison Research

Second-quarter operating margins excluding royalties were 44.7 per cent if the £5m bonus to employees were stripped out. Based on a back of the fag packet estimate of £170m of sales in the second half at a 40 per cent margin, with £5m of extra royalties, would get to an operating profit figure of £165m for the full year.

Games Workshop: H2 and FY Guesstimate

£m	H2F	FY 21F
Sales	170	356.8
Op Profit	68	151.3
Margin	40%	42%
Royalties	5	13.7
Total op Profit	73	165

Source: Investors Chronicle

This would give EPS of around 407p. At £107.50 that would put the shares on a PE of 26.4 times which would not be bad value for the blend of quality and growth on offer. Time will tell as to whether this is wide of the mark.

Looking further out, I must admit that I have no idea what the ultimate potential of this business is. I don't know how much of the current boom is due to temporary (hopefully) lockdown effects which have boosted many hobby activities. Then I ponder what will happen to margins when the stores reopen and some sales shift back to them.

However, I think that the potential in the US is still pretty decent whilst progress in the Chinese market could bring further gains.

I retain my view that royalties from leveraging the intellectual property of Warhammer are a nice thing to have rather than a key driver of the share price. The company again confirmed in its results statement that it would take great care that licensed computer games and media would not harm the core miniatures business.

I am not too bothered about the forecasts and guidance and feel reasonably happy that the strong fundamentals behind this business remain intact. The shares therefore stay in both fantasy portfolios.

Games Workshop: Current Forecasts

Year (£m)	2021	2022	2023
Turnover	349.4	377.9	398.3
Ebitda	165.4	179.1	183.7
Ebit	138.9	157	168.5
Pre-tax profit	141.5	154	162.1
Post-tax profit	109.5	122	-
EPS (p)	344.6	373.2	386.4
Dividend (p)	200	230.4	220
Capex	20.3	20.5	25.5
Free cash flow	119	123	-
Net borrowing	-96.5	-130	-

Source: SharePad

Asos

I added **Asos (ASC)** to the UK portfolio at the start of the year. I did so because I believe the company has put in place a customer-friendly business model backed by investment in infrastructure that can capitalise on the growth of savvy young people buying fashion items over the internet across the world. The combination of its own brands and leading brands means that it has an attractive offer.

It is the prospect of many years of growth and hopefully the compounding in equity value that this can create, combined with a more reasonable valuation, that leads me to hope that it will be a decent long-term investment.

	Four months to 31 December			
£m[3]	**2020**	**2019**	**Reported Increase**	**CCY[4] Increase**
UK retail sales	554.1	408.9	36%	36%
EU retail sales	*390.7*	*332.5*	*18%*	*18%*
US retail sales	*156.8*	*139.3*	*13%*	*17%*
ROW retail sales	*224.2*	*194.2*	*15%*	*20%*
International retail sales	771.7	666.0	16%	18%
Total retail sales	**1,325.8**	**1,074.9**	**23%**	**24%**
Total group revenue[5]	**1,364.1**	**1,106.0**	**23%**	**24%**

Source: Asos

Wednesday's trading update was pretty encouraging and shows that the company is a beneficiary of lockdowns – as bricks and mortar stores are closed – as well as tapping into a long-term growth market.

Demand and sales were ahead of the company's expectations driven by very strong growth in the UK and growing momentum in the US, Australia and the Middle East. Despite gross margins falling back 90 basis points, due to changes in mix and higher freight and marketing costs, the company continues to benefit from lower levels of order returns. This improves sales and also avoids the costs that come with them. This is expected to provide a benefit of at least £40m of pre-tax profits in the first half of the year to February 2021.

People will obviously question what happens to profits when things get back to normal. Time will tell, but it's not unreasonable to think that a large chunk of these extra profits could disappear. The company also said that it expected to incur £15m of extra tariff costs related to the new UK/EU trade deal, due to rules of origin effects.

That said, this is a business that is clearly making progress as evidenced by the gain of over 1m customers to 24.5m. These new sales help to offset lower sales from existing customers, who spent less due to fewer social occasions in the pandemic which meant less need to buy new clothes.

The company continues to invest for future growth with a fourth UK fulfilment centre in Lichfield and the automation of its US fulfilment centre later this year.

Asos: Current Forecasts

Year (£m)	2021	2022	2023
Turnover	3,847.80	4,438.80	5,066.40
Ebitda	294.6	340.8	398.8
Ebit	154.4	184	224.6
Pre-tax profit	147.1	176.3	214.4
Post-tax profit	122.1	142	176
EPS (p)	124.6	147.5	179.2
Dividend (p)	-	-	-
Capex	180.2	191.1	206.9
Free cash flow	27.4	126.3	179.2
Net borrowing	-402.7	-406.2	-590.8
NAV	928.2	1,069.80	1,239.70

Source: SharePad

The good news for shareholders is that pre-tax profit for 2021 is now expected to be at the top end of analysts' forecasts, which implies a number of around £170m that represents a big upgrade on current consensus. At £53.50, this would put the shares on a

punchy 2021F of 37.5 times, but for a business that offers healthy revenue and profit growth in a low interest rate world that looks reasonable to me.

Frontier Developments

Frontier Developments (FDEV) has demonstrated an ability to create video games that players stay and engage with for a long time. When combined with a pipeline of new games from its own developers, licences and its third party publishing business, it offers the prospect of strong future revenue and profits growth.

Wednesday's trading update contained a mixture of encouraging and slightly disappointing news. The good news was that trading in the current financial year is ahead of management's expectations due to very strong trading in the Christmas period. The disappointment came with the announcement that the eagerly anticipated release of *Elite Dangerous: Odyssey* has been delayed again. Having been expected to launch in February it now looks like it will be in May instead.

The company has coped with lockdown well with home working not seemingly causing too many issues. However, some of the benefits of employee interaction which come with on site working have been lost and may not have been helpful in putting the final touches on the Odyssey release.

Quite rightly, Frontier does not want to release this until it is working perfectly and delivers the experience that its loyal fans (and many new ones it has gained in recent months) expect. Minor teething troubles also mean that it will only be initially released on PC – the main platform for Elite Dangerous – with XBox and Playstation releases being

shifted into 2022. The release of Lennis Gate through the Frontier Foundry has also been delayed until 2022.

This is hopefully a temporary setback, but Frontier needs to be careful that this does not become a regular habit as it has the potential to damage the goodwill it has built up amongst its players.

The strength of the existing games portfolio means that current revenue guidance for the year to May 2021, of £90m-£95m, remains intact. The shifting of game releases into 2022 now means that the guidance range for revenue of £133m-£153m will need to be revised upwards.

The shares ended 2020 on a very strong note and some pause for breath was probably warranted. The long-term outlook for the business still looks very positive, as the company has laid the foundations for many years of strong revenue and profit growth. This outlook is reflected in the current one-year forecast rolling PE of 52.8 times at a share price of 3,237p, but long-term investors should not be put off by this, in my view.

The shares stay in both the UK and Fantasy Sipp portfolios.

Frontier Developments: Current Forecasts

Year (£m)	2021	2022	2023
Turnover	93.3	141.8	164.1
Ebitda	36.5	54.7	62.6
Ebit	19.8	32.3	37
Pre-tax profit	20.2	30.5	39.6
Post-tax profit	19	27.8	38.1
EPS (p)	48.4	70.8	85.5
Dividend (p)	-	-	0.1
Capex	24.3	30.3	32.6
Free cash flow	10.4	21.4	29.8
Net borrowing	-54.4	-76	-109.4

Source: SharePad

Just Eat Takeaway.com

Just Eat (JET) is a business that has thrived in the lockdowns as more people order takeaway food. It has already built up a prominent brand in the food delivery market and is aiming to dominate it.

This is a company that will undoubtedly attract the attention of investors who are interested in developing businesses that can go on to become a major part of many people's day-to-day lives. It faces strong competition in the form of Uber Eats and Deliveroo in its UK market, while its upcoming acquisition of Grubhub in the US will also put it up against the likes of DoorDash.

Just Eat has set out its strategy to compete on price by offering competitive commission and delivery fees to restaurants. It is investing heavily in its own delivery service to woo restaurants that do not do their own delivery. This means that the winning of market share is taking precedence over profitability right now.

This week's trading statement shows that its plans are bearing fruit with a very strong performance in the last quarter of 2020.

Total order growth was 57 per cent whilst delivery orders soared by 163 per cent. In the UK, where lots of investment is going into delivery, delivery orders were 387 per cent higher than they were a year ago.

This strong operational performance has fed through into revenue growth of over 60 per cent, with an expected range of €720m-€740m, compared with €451m a year ago. Revenue growth for the whole of 2020 will be more than 50 per cent, with adjusted

earnings before interest, tax, depreciation and amortisation (Ebitda) margins of around 10 per cent.

There is a very good business here. Gross profit margins – which are stated after courier costs – were 61 per cent in the first half of 2020. What the company now needs to do is leverage these profits with volume growth in order to make good on the investments it has made in its business.

Current analyst forecasts suggest that it is expected to do this over the next few years, but there are risks along the way. The integration process between Just Eat and Takeway.com is still ongoing, while it will soon have to integrate Grubhub as well which has been losing money. This is no small task for management and creates significant execution risk for the business strategy. However, if the integrations go well there is scope to do this.

Just Eat: Orders and Deliveries Q4 2020

(in millions)	Fourth quarter 2020	2019	Growth	Constant currency
Total Orders[1]	**179.8**	**114.9**	**57%**	
United Kingdom	56.0	35.5	58%	
Germany[2]	34.7	22.4	56%	
Canada	25.6	13.1	94%	
Netherlands	14.0	10.1	39%	
Rest of the World	49.5	33.8	47%	
Delivery Orders	**54.9**	**20.9**	**163%**	
United Kingdom	14.2	2.9	387%	
Germany[3]	2.4	1.3	93%	
Canada	24.5	12.2	100%	
Netherlands	1.3	0.6	129%	
Rest of the World	12.5	3.9	221%	
GMV (in billions €)	**4.0**	**2.4**	**64%**	**68%**
United Kingdom	1.2	0.7	54%	62%
Germany[4]	0.8	0.5	72%	72%
Canada	0.5	0.3	91%	103%
Netherlands	0.3	0.2	56%	56%
Rest of the World	1.2	0.7	61%	62%
Revenue[5] (in millions €)	**720-740**	**451**	**>60%**	

Source: Just Eat

Competition is intense with aggressive use of vouchers and discounts used in order to take market share. The cost of defending, as well as growing, market share is a risk to profit margins.

That said, there is potential for stronger operators to benefit from powerful network effects, as the more restaurants that list on their site the more valuable the business can become. The investment in delivery is therefore crucial in getting some restaurants to join and stay with it. Just Eat's delivery contracts with McDonald's and exclusive deal with Greggs in the UK suggest that its investment is delivering good results.

As with many businesses that have benefited from Covid-19 lockdowns, there is the question of how much of its revenue will ultimately have been exceptional or one-off in nature. We do not know what will happen to takeaway orders and order frequency when things get back to normal.

Just Eat Takeaway.com: Current Forecasts

Year (€m)	2020	2021	2022
Turnover	2,311.60	2,705.70	3,235.50
Ebitda	343.5	403	598.8
Ebit	184.2	260.8	453.9
Pre-tax profit	128.4	173.4	369.4
Post-tax profit	86.5	134	279.1
EPS (c)	51.1	101.8	203.5
Dividend (c)	-	-	-
Capex	79.4	85.3	94.3
Free cash flow	150.3	223.6	400.4
Net borrowing	-219.7	-617.7	-1,206.80

Source:SharePad

Current forecasts do not reflect the contribution of the Grubhub acquisition and the new shares that will be issued. At a share price of £86.41, the shares are on a 2022F PE of nearly 48 times, which is not cheap by any means, and suggests a lot of good news and strong growth is priced in. If the Grubhub acquisition goes well and the company can build a significant presence in the US then the shares could still be a decent long-term investment from here.

Persimmon

After having a horrible time for much of 2020, housebuilders are in a good place right now but it probably won't last for much longer.

With both the Help to Buy scheme in its current form and the stamp duty holiday due to end at the end of March, builders are trying to sell as many houses as they can to benefit from these generous subsidies.

Persimmon (PSN) has ended 2020 in a good position with a forward order book of £1.7bn vs £1.36bn a year ago, but clouds are gathering for 2021. The company has benefited from pent-up demand and has generated sales from fewer sites, but from March onwards it will be facing tougher trading conditions.

As far as 2021 profits are concerned, it will come up against very weak comparatives between March and June, but the company is rightly taking a cautious approach. Sales have been weaker in recent weeks and stock availability has become an issue in some circumstances. This will not have been helped by having 500 fewer homes as work in progress compared with a week ago.

The company has plans to open up more sites over the coming months, but there is considerable uncertainty as to how the sector will perform once the stamp duty holiday ends and the new Help to Buy with regional price caps comes into force.

Existing land banks should have healthy profit margins baked into them as long as selling prices hold up. However, I do feel that the return of stamp duty could introduce a combination of both selling price and volume risk, which could put profits under pressure despite the forward selling position.

Growth in profits is going to be a challenge, in my view, once trading conditions have normalised. At 2.4 times 2021F book value, Persimmon shares are not particularly cheap either.

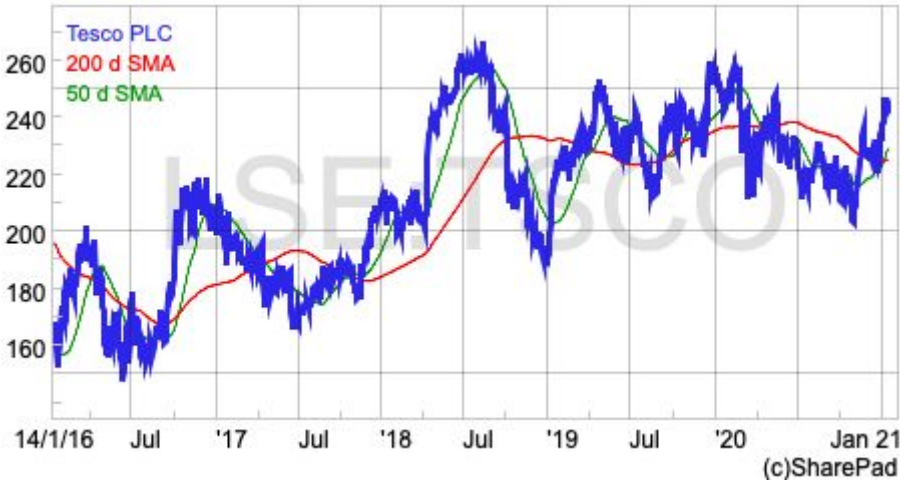
That said, with a relatively benign housing market profitability and cash generation will be strong, which will allow the resumption of chunky dividend payouts. On 2021 forecasts, the shares offer a prospective dividend yield of more than 8.3 per cent. That will attract income-seekers, but those who rightly focus on potential total returns from the shares should be wary.

Persimmon: Current Forecasts

Year (£m)	2020	2021	2022
Turnover	3,214.60	3,457.60	3,582.50
Ebitda	863.5	949.6	968
Ebit	853.3	935.2	959.5
Pre-tax profit	861.6	932.1	962.7
Post-tax profit	700.5	763.1	789.2
EPS (p)	219.3	240.4	247.7
Dividend (p)	110	220.3	230.3
Capex	19.4	19.1	20
Free cash flow	445	798.6	734.2
Net borrowing	-986.2	-1,095.10	-1,135.90
NAV	3,535.60	3,450.90	3,484.40

Source: SharePad

Tesco



Tesco's (TSCO) third-quarter and Christmas trading statement revealed that its core UK grocery business is trading well. The Christmas period saw like-for-like (LFL) sales increase by a very healthy 8.1 per cent, but was not as good as the increases achieved by Sainsbury's and Morrisons, as both saw sales grow by more than 9 per cent.

Booker's retail business has held up well, but sales into the catering and hospitality sectors halved on a LFL basis.

It is encouraging to read that Tesco's Aldi price match, which was launched last March, continues to resonate with its customers. Clubcard pricing – which offers selected price discounts to Clubcard holders – is also proving to be popular and has increased the proportion of sales in larger stores amongst Clubcard holders to 80 per cent. Tesco reckons that it is at its most price competitive relative to the grocery market as a whole in a decade.

My regular weekly shopping trips to Tesco would back this up. I am a member of the Clubcard + scheme, which has a monthly subscription cost of £7.99 and gives 10 per cent off two big shops in store per month up to a total of £200 (£400 per month). I reckon this gives our family budget a net profit averaging about £18 per month, which is well worth having. My estimate is that Clubcard pricing takes another 4 per cent off the weekly bill. Combined with general everyday low pricing elsewhere, I know that I am making good savings compared with shopping at Sainsbury's or Morrisons.

While these initiatives are good for customers, it highlights just how much money is having to be invested in price to stay competitive. Some of this will be paid for by supplier promotions, but it still seems that Tesco and the bigger supermarkets in general are having to work very hard to hang on to and win market share.

Tesco Bank is in a bit of a mess and is still on course to lose between £175m and £200m this year due to increasing bad loans. The sooner Tesco gets rid of this business the better it will be for shareholders.

While sales growth is strong, it's not doing anything for profit, as the costs of making stores Covid-safe has eaten up the extra contribution. Tesco expects its core annual retail profits – excluding the repayment of business rates – to be the same as last year.

I think Tesco has firmly got its UK business back on track as a customer-friendly business. The problem it - and other big supermarkets - faces is that any meaningful growth looks unlikely. Cost savings are likely to be reinvested in price cuts, while selling groceries over the internet is not as profitable as doing it from stores.

The key investment attraction of Tesco shares, as I see it, is dividend income. A £5bn special dividend with a share consolidation will take place on 26 February from the sale proceeds of its Thailand and Malaysia business. At 241p, the expected annual dividend gives a yield of 3.5 per cent with the prospect of real - above inflation - dividend growth for a few more years.

Tesco: Current Forecasts

Year (£m)	2021	2022	2023
Turnover	59,214.70	60,253.10	61,183.30
Ebitda	4,016.20	4,494.00	4,643.90
Ebit	2,355.80	2,700.50	2,833.50
Pre-tax profit	1,513.80	2,006.60	2,142.00
Post-tax profit	1,084.90	1,526.40	1,663.20
EPS (p)	12	18.3	19.8
Dividend (p)	8.5	9.4	10.1
Capex	997.8	993.5	1,003.50
Free cash flow	1,369.60	2,030.50	2,092.20
Net borrowing	10,612.50	9,083.20	8,272.30

Source: SharePad

Whitbread

As far as **Whitbread (WTB)** is concerned, its current losses are largely irrelevant as long as they don't get too big. With its hotels that are open only around a third full at the moment (in normal times they have 80 per cent occupancy rates), the key uncertainty is how much net debt it will have when the lockdown ends. It ended 2020 with net cash of £40m and has enough access to cash through its banking arrangements to hopefully see it through this very difficult period.

The company is taking market share of independent operators in the UK and looks set to come out of this crisis with Premier Inn in a much stronger competitive position. A recovery of profits should be strong when it eventually occurs, but it should not be forgotten that Premier Inn was struggling to grow its LFL sales in the UK before the pandemic. I have concerns that a subdued business travel market after lockdown could weaken its recent investments in London and elsewhere across the UK.

My other concern is that return on capital on Premier Inns in the UK has been trending downwards over the past few years and that incremental returns on new investments may not be as rewarding.

I must admit that I find the company's expansion into Germany a little bit underwhelming and sluggish. It has around 820 hotels in the UK with over 78,000 rooms, but only 29 operational hotels in Germany with a pipeline to take this to 68. It's going to be quite a long time before Germany has a meaningful impact on Whitbread's profits.

There remains the prospect of some corporate spice with this company. After years of dithering, it eventually sold off Costa Coffee and got a very good deal for its shareholders. Now may not be the right time, but Premier Inn has significant and valuable asset backing that could be released with a change in business model.

The move from on owner-operator to a franchisor model worked very well for Inter-Continental Hotels and Premier Inn looks like it would be well suited to franchising. If Whitbread won't go down this route itself, one day someone else may come along and do it.

Analysts are currently predicting that it will take until March 2023 before this business is back to something like its old self in terms of revenue, but with operating profits well short of the £538m it made in 2019. On 2023 forecasts, the shares trade on a PE of 30.3 times, at 3216p. The shares may mark time for a while before investors have more certainty on its profit recovery.

Whitbread: Current Forecasts

Year (£m)	2021	2022	2023
Turnover	756.4	1,663.00	2,039.00
Ebitda	-169.9	412.6	709.5
Ebit	-429	140.9	395.9
Pre-tax profit	-591.7	-37.5	270.6
Post-tax profit	-468.5	-14.2	213.4
EPS (p)	-255.9	-2.7	106.1
Dividend (p)	9.8	16.1	49.9
Capex	272.6	400.2	458.8
Free cash flow	-592	-73.3	63.9
Net borrowing	2,684.40	2,862.00	2,982.70
NAV	3,965.00	3,916.50	4,033.80
Like-for-like sales growth (%)	-14.3	10.2	2.2

Source: SharePad

Associated British Foods

Primark is being hammered by Covid lockdowns as it has no internet business to offset the damage (the low selling price of many of its products makes it difficult to stack up). This is a shame as the rest of its business is performing really well. The previously problemsome Sugar business is actually being helpful right now.

AB Foods: Year-to-Date Revenues

	Year to date £m	Last Year £m	
Grocery	1,222	1,142	+7%
Sugar	545	512	+6%
Agriculture	507	463	+10%
Ingredients	497	484	+3%
Total Food	2,771	2,601	+7%
Retail	2,031	2,904	-30%
Group	4,802	5,505	-13%

Source: AB Foods

Seventy five per cent of Primark stores are currently closed under lockdown restrictions. The company is managing to save 25 per cent of store operating costs, but the damage in terms of lost revenues and profits is severe.

	Store overview		Closed Stores	
	# of stores	sq ft 000	# of stores	sq ft 000
UK	190	7,552	190	7,552
Spain	50	2,050	10	368
Germany	32	1,841	32	1,841
Republic of Ireland	36	1,076	36	1,076
France	19	996	-	-
Netherlands	20	971	20	971
US	11	548	-	-
Belgium	8	403	-	-
Portugal	10	383	10	383
Austria	5	242	5	242
Italy	6	307	-	-
Slovenia	1	46	1	46
Poland	1	40	1	40
Total	389	16,455	305	12,519

Source: AB Foods

The company reckons that if the lockdown continues until the end of February (which looks very likely), then it will lose over £1bn of sales from Primark. Having made £441m of operating profit in the first half of last year, Primark would break even. If the lockdown continues until the end of March, a further £800m of sales and £300m of profit would be lost.

At the moment, it seems that investors are prepared to look through this. The strength of Primark as a brand was demonstrated when the first lockdown ended last Spring with people queuing from the early hours of the morning before the stores reopened.

The long-term potential of the brand remains very strong in my view and is evidenced by resilient performances on UK retail parks and in the US. The business is still on course to add 0.7m square feet of selling space this year and has plenty of scope to keep rolling out the brand globally for many years to come.

The business is expected to have £500m of net cash before lease debt at the end of its half year, and with strong trading from its other business it can weather the current storm at Primark comfortably.

This is a business I continue to like and while the current problems are disappointing, the quality and robustness of its other business is at the best it has been for some time. This is a relatively new addition to the UK Quality portfolio and I'm happy to stick with it.

AB Foods: Current Forecasts

Year(£m)	2021	2022	2023
Turnover	15,357.30	16,411.30	17,184.00
Ebitda	2,072.10	2,385.40	2,541.80
Ebit	1,251.90	1,535.70	1,652.20
Pre-tax profit	1,158.10	1,454.40	1,553.80
Post-tax profit	873.9	1,110.30	1,193.10
EPS (p)	110.3	138.8	149
Dividend (p)	37.7	48.7	52.7
Capex	739.9	816.5	855
Free cash flow	752.8	1,044.70	1,079.10
Net borrowing	-512.2	-822.7	-2,348.50
NAV	-9,977.20	-10,606.50	-11,281.70
Like-for-like sales growth (%)	9.1	5	3

Source: SharePad

Dunelm

Dunelm has gone from a position of having a very poor internet operation not so long ago to having a very good one. This is just as well, with all of its shops currently closed it needs it.

The company has done a great job in positioning itself as a go to place for homewares and has combined its in-store offer and online business very well. Very strong LFL sales growth has been achieved, as it has taken a lot of market share in recent years from weaker competitors.

This has continued in its second quarter with LFL sales growth of 10.8 per cent. This is a big slowdown from the 35.7 per cent in Q1, but it is still an impressive number that most UK retailers would be more than happy with. This should see the company deliver first-half pre-tax profits of around £112m, compared with £83.6m last year.

The second half of the year looks more difficult with the company not giving any guidance in its trading update.

As well as selling more stuff, Dunelm has benefited from better sourcing of its products over the past couple of years, which has improved its gross margins. That benefit seems to have run out for the time being with gross margins expected to be flat in the second half of the year.

At the moment, click and collect is covering the overheads of its closed stores. John Lewis suspended its click and collect service this week and there must be a risk that the government follows the lead of Scotland, which has banned non essential retail click and collect this week. If this happened then profits would take a temporary, but significant, hit.

The share price sold off heavily on Thursday morning to reflect these fears. With the shares still trading on more than 20 times prospective earnings, the case for a further upwards rerating is not there right now.

Dunelm: Current Forecasts

Year(£m)	2021	2022	2023
Turnover	1,287.40	1,302.80	1,370.70
Ebitda	238.8	236	259.8
Ebit	160.1	157.2	169.3
Pre-tax profit	151.9	151.1	164
Post-tax profit	122.5	122	132.6
EPS (p)	60.5	59.5	64.7
Dividend (p)	27.7	31.1	33.1
Capex	27.8	30.6	50.4
Free cash flow	59.6	165.6	171.4
Net borrowing	-28	-50.7	-25.3

Source: SharePad

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ISSN 0261-3115.