Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

9th December 2016

Market overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	6931.55	▲2.65	▲1.29	▲13	7097.5	5536.97	10/10/16	11/2/16
FTSE 250	17682	▲1.06	▲1.34	▲2.85	18342.1	14967.9	4/10/16	27/6/16
FTSE SmallCap	4988.41	▲1.49	▲2.31	▲9.77	5051.49	4145.59	10/10/16	12/2/16
FTSE AIM 100	3879.03	▼-0.306	▲1.06	▲10.6	3993.45	3075.85	4/10/16	11/2/16
S&P 500	2248.36	▲2.61	▲5.09	▲8.95	2248.36	1829.08	8/12/16	11/2/16
UK Treasury 10 Year Par Yield	1.44	▼-4	▲14.3	▼-20.9	2	0.61	30/12/15	12/8/16
Brent Oil Spot $	$53.76	▲0.13	▲17.3	▲32.9	$54.42	$27.765	2/12/16	20/1/16
Gold Spot $ per oz	$1170.99	▼-0.227	▼-8.05	▲8.81	$1366.48	$1053.12	6/7/16	17/12/15
GBP/USD - US $ per £	1.25711	▼-0.141	▲1.5	▼-16.2	1.52215	1.21697	11/12/15	27/10/16
GBP/EUR - Euros per £	1.1847	▲0.347	▲5.39	▼-14	1.3851	1.1066	11/12/15	13/10/16

It has been a good week for shares with the FTSE 100 in the UK and S&P 500 in the US posting strong gains. The FTSE 100 is now up 13% over the last year which is a pretty respectable result that will please many investors. US stock markets continue to benefit from a "Trump rally" as the incoming president's policies are seen as being good for company profits.

The pound made a slight gain against the euro but nothing too dramatic as the result of the Italian referendum did not lead to the widespread panic that some commentators predicted.

Gold and oil were broadly unchanged, but UK bond yields continued to nudge higher, continuing their rise of recent weeks.

Should investors use stop losses?

I recently received an email from a SharePad subscriber asking for my opinion on the use of stop losses. A stop loss is when you set yourself a limit for a share price to fall from your buying price before selling. So if you bought a share for 100p and you have a 20% stop loss, you will sell the share if it falls to 80p.

I have mixed views on stop losses. If you are spread betting where losses can be many times your stake then stop losses are probably a good idea.

In the normal process of investing in shares I am not generally in favour of them. Nobody likes to look at their share dealing account and see big losses. However, remember that you only suffer a loss if and when you sell.

Share prices are very volatile and it is not unusual to see prices fall heavily from time to time. This plays havoc with people's emotions. There is a tendency to panic and think that your losses will get even bigger.

If you are a long term investor and you have done your homework then I think stop losses are a bad idea. Share prices can fall temporarily and can be a lot higher a few years later if the business behind the share remains sound. Many investors end up kicking themselves for panic selling when they should have kept a cool head.

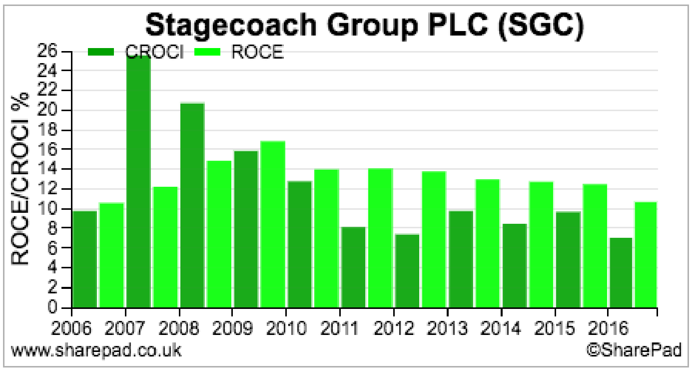
Providing you have bought the shares of a good quality company at a fair price then a falling share price is not a reason to sell. In fact, it might be a reason to buy more as long as the fundamentals remain sound. You should only sell when the fundamentals deteriorate and permanently change the future prospects of the business.

Share Discussion: Stagecoach (LSE:SGC)

Shares of bus and rail operator Stagecoach have experienced a sharp fall in their price during the last year. Not so long ago, its businesses seemed to be thriving with growing profits and margins.

This week's half year result shows that investors are right to have concerns over the company's future prospects. Trading profits were down by nearly 20% and earnings per share (EPS) was down by more than 15%. However, the interim dividend was increased by a healthy 8.6% which will undoubtedly have given some comfort to long-standing shareholders.

Stagecoach's problem is about how it is going to start growing its profits again. It also has to address a steady decline in its return on capital employed (ROCE) over the last few years.



Theoretically, the outlook should be very favourable for bus companies. The UK has an ageing population and increasing levels of congestion in urban areas. Both these factors should lead to more people using buses and bus companies making more profits. It is not working out this way. The company's bus profits fell slightly during the first half of its financial year.

Pensioners get free bus travel but the increases in retirement age mean that they are having to wait longer to get their bus passes. This is slowing the rate of passenger growth from older people.

School bus services are also having their budgets cut as local authorities look to save money and this too has meant less money going to bus companies such as Stagecoach.

Urban congestion is not working in Stagecoach's favour either. In many town and cities buses are actually seen as a cause of congestion rather than the solution to it. Unless local authorities build special bus lanes then people are not going to see buses in a favourable way, especially when cheaper fuel prices currently make driving an inexpensive option. In the short run, the outlook for Stagecoach's bus profits is not too good.

Half year rail profits more than halved. The company's East Coast rail franchise continues to be a major risk for shareholders. It has to pay significant - and rising - amounts of money to the government to run it until 2023 and needs lots of revenue growth to pay the bill.

Revenue growth is currently a lot lower than the company needs it to be. This rail franchise has significant scope to blow a hole in the company's future profits. Elsewhere in its rail portfolio, the South West and East Midlands franchises expire in 2017 and 2018 respectively. The company may retain these but will profits be higher or lower than they are now?

City analysts are not predicting any EPS growth for 2018 and 2019 and expect the rate of dividend growth to slow dramatically. Dividend cover is also expected to fall.

Stagecoach Group PLC (SGC)

← Prev Next →	2014	2015	2016	2017	2018	2019
Fiscal period ending	30/4/14	30/4/15	30/4/16	1/4/17	1/4/18	1/4/19
£ millions unless stated	Q4	Q4	Q4	Forecast	Forecast	Forecast
KEY FORECASTS						
Turnover	2,930.0	3,204.4	3,871.1	4,016.8	3,208.5	2,783.6
%chg	▲4.5	▲9.4	▲20.8	▲3.8	▼-20.1	▼-13.2
EBIT	212.4	213.5	179.6	187.2	165.3	137.8
EBIT margin	7.2	6.7	4.6	4.7	5.2	5.0
EPS(p)	23.9	25.2	21.9	25.1	22.2	21.9
EPS % chg	▲2.5	▲5.6	▼-13.3	▲14.9	▼-11.6	▼-1.4
DPS(p)	9.5	10.5	11.4	11.9	12.3	12.8
DPS % chg	▲10.5	▲10.5	▲8.6	▲4.4	▲3.4	▲4.1
Dividend cover	2.5	2.4	1.9	2.1	1.8	1.7

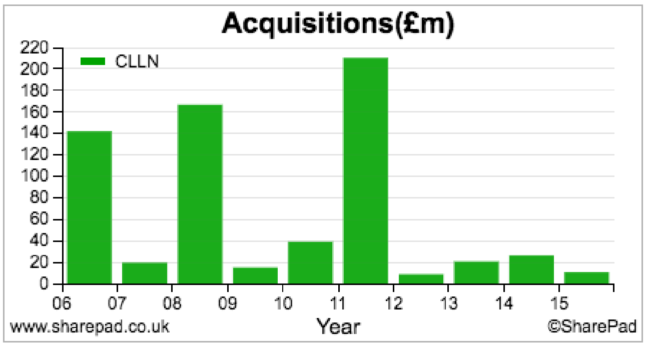
However, a lot of this gloomy outlook seems to be priced into the shares. They trade on a forecast PE of 8.4 times and a very high yield of 5.6%. I think the dividend is safe barring a big problem with the East Coast rail franchise. If the company was to retain its South West Trains franchise next year then this would offset some of the risk from East Coast and could improve sentiment towards the shares which have a dark cloud hanging over them at the moment.

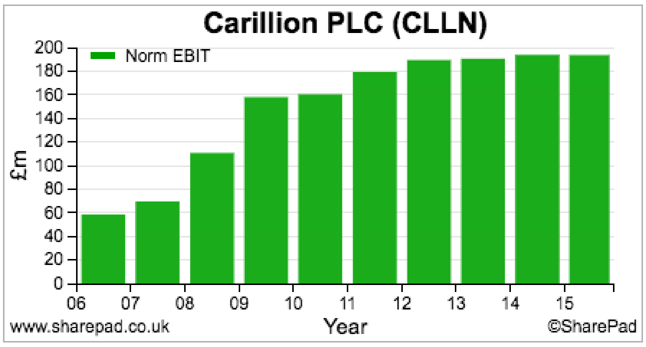
Share Discussion: Carillion (LSE:CLLN)

In some ways, the shares of construction and support services company Carillion are quite similar to Stagecoach. The shares have a very big dividend yield and the company is struggling to grow its profits. Yet, I think Carillon shareholders potentially face a worse outlook.

Carillion shares have not been a very good long-term investment and trade significantly below prices seen a decade ago. The company had a tendency to grow by making acquisitions and powering EPS growth by making lots of cost savings. This masked the fact that underlying profits were not growing by much at all. When those cost savings ran out, it either had to make another acquisition or see its profits growth fall.

Carillion's failure to buy rival Balfour Beatty in 2014 showed this weakness and profits growth has been weak.





This week's trading update suggests that the company will struggle to grow in 2016 and 2017. Its Support Services business is performing reasonably well but the outlook for its construction business has weakened.

A slowing of orders from the UK government is not helpful for either business. Low oil prices have resulted in lower construction revenues in the Middle East.

The key issue for shareholders remains the sustainability of the dividend. I think there is a good chance that it will be cut and the high yield of 7.8% seems to suggest that the stock market thinks it will be as well.

The reason is Carillion's poor free cash flow which could get worse for two reasons:

1. A very big pension fund deficit which will use up a lot of cash flow.
2. A decline in cash from selling stakes in public private partnerships (PPPs).

The table overleaf shows that Carillion's free cash dividend cover has been very volatile. Since 2010, it has paid out nearly £100m more in dividends than it has generated in free cash flow. It has been able to do this by selling assets and investments.

The value of these investments has shrunk significantly and was only £46m at the end of 2015. The company cannot rely on big asset sales for much longer. Unless it starts generating significantly higher free cash flow then its dividend looks to be unsustainable.

Year	Free cash flow	Cash dividends	Gap	Disposals	Gap after disposals
2010	144.1	61.4	82.7	45.8	128.5
2011	126.8	68	58.8	31.4	90.2
2012	-22.7	78.6	-101.3	0	-101.3
2013	-71.2	75.7	-146.9	143.7	-3.2
2014	112.2	76.7	35.5	36	71.5
2015	56.5	80	-23.5	54.1	30.6
Cumulative	**345.7**	**440.4**	**-94.7**	**311**	**216.3**

Share Discussion: Ashtead (LSE:AHT)

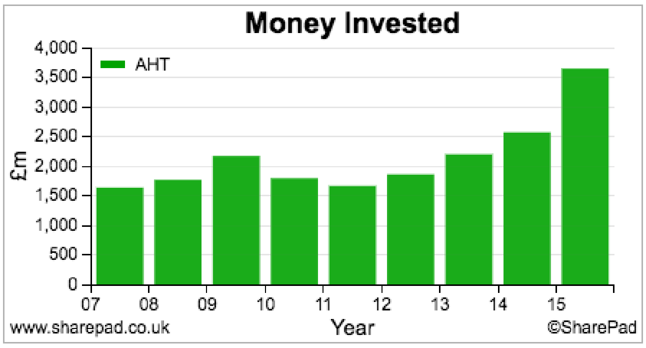
Ashtead makes its money by renting out equipment to construction and industrial companies - things like tools, diggers, cranes, power generators and pumps. It makes most of its profits in America and its shares have been a terrific investment. They have been a proverbial ten bagger over the last decade.

During my time as a professional analyst I spent many hours looking at rental companies. Historically, the stock market has viewed them with a healthy dose of scepticism. They are renowned for being cyclical boom bust companies whilst some have been prone to dodgy accounting.

In order to understand a rental company you need to focus on a few key numbers.

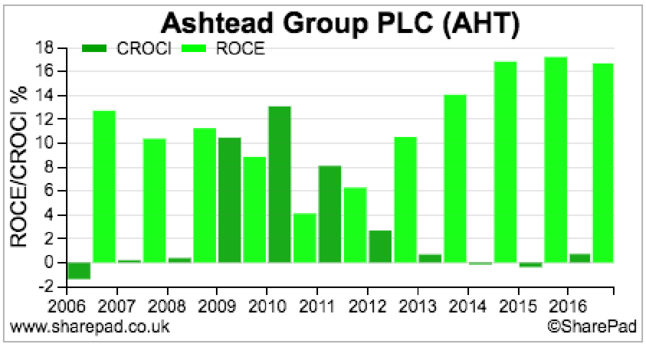
- The size of the rental assets - how much is available for hire.
- How many of the assets are out on hire - known as the utilisation rate.
- The hire rate.
- The profits or losses from selling assets. This tells you whether profits from the core rental business are believable or not. I'll explain this in more detail shortly.

So if a rental company can grow its asset base, making sure those assets are highly utilised without cutting hire rates, it can make an increasing amount of money. Ashtead has proven itself to be very good at doing this.



The company has significantly increased the amount of money invested in its business (capital employed) and has earned higher returns on that money (ROCE).

Note that this growth comes at a cost - very poor free cash flow. Ashtead requires a lot of cash to grow. Last year it ploughed back virtually all of its operating cash flow into new assets. Over the last decade its capex ratio (capex to operating cash flow) has averaged 73%. This explains why is free cash flow return on investment (CROCI) has been so low. These companies only tend to produce lots of free cash flow when they stop growing.



This week, the company released a very strong set of half year results with trading profits up by 13% and a 19% hike in the interim dividend. Utilisation rates remained at 73% and profit margins nudged up slightly. The outlook statement was upbeat as the company said its profits would be ahead of expectations.

However, it is worth noting that the company received a significant boost from the fall in the value of the pound. US profits were up by 8.8% in dollar terms but by 25.4% when they were converted back into pounds. It is unlikely to get a similar boost next year.

The other key thing to keep an eye on is whether the company is making profits or losses when it sells its rental assets. This tells you if the company is depreciating them at the right rate. A company can boost profits by under depreciating its assets but will lose money when it sells them as the cash received will be less than the balance sheet value of the asset.

Let's say that two identical rental companies buy the same asset for £100. They keep it for three years and then sell it for £45.

Asset cost (£)	**100**	**100**
Year 1 Depreciation	-20	-10
Year 2 Depreciation	-20	-10
Year 3 Depreciation	-20	-10
Net book value at end of year 3	**40**	**70**
Cash received from selling	45	45
Profit or loss on disposal	**5**	**-25**

One company depreciates it at £20 per year for three years meaning it is valued at £40 at the end of year 3. The other only depreciates it at £10 per year giving it a balance sheet value of £70.

The second company has reported £30 higher profits than the first one by charging a lower rate of depreciation. However it loses £25 on its asset value when it sells it whereas the first company makes a profit of £5.

The losses tell you that the company was inflating its profits whereas a profit tells you that the company's profits were prudently stated. The good news for Ashtead shareholders is that it has been reporting small profits on asset disposals which suggests that its profits are fairly stated.

You can check for profits on disposals by looking at the reconciliation of the company's operating profit to operating cash flow. In the *Operating* section of the cash flow statement, profit on the sale of assets will be shown as a reduction from operating profits (see image on the right). This is because it is not an *operating* flow of cash. Losses will be added back to operating cash flow. You'll find the actual cash flow recorded in the *Investing* section of the cash flow statement.

13. Notes to the cash flow statement

	Six months to 31 October 2016 GBPm	2015 GBPm
a) Cash flow from operating activities		
Operating profit before amortisation	474.4	382.1
Depreciation	283.0	209.7
EBITDA before exceptional items	757.4	591.8
Profit on disposal of rental equipment	(6.8)	(20.3)
Profit on disposal of other property, plant and equipment	(0.1)	(0.4)
Decrease/(increase) in inventories	2.8	(5.6)
Increase in trade and other receivables	(82.0)	(65.5)
Increase in trade and other payables	29.4	1.5
Other non-cash movements	2.8	2.4
Cash generated from operations before exceptional items and changes in rental equipment	703.5	503.9

Rental companies often fund their businesses with lots of debt which can cause problems if profits start falling. Ashtead looks to be prudently financed at the moment with net debt to EBITDA of 1.8 times (anything over 2.5 times would be worrying) and interest cover of 9.8 times.

It seems that analysts think that the good times can keep on rolling for Ashtead.

Ashtead Group PLC (AHT)

Prev Next	2013	2014	2015	2016	2017	2018
Fiscal period ending	30/4/13	30/4/14	30/4/15	30/4/16	1/4/17	1/4/18
£ millions unless stated	Q4	Q4	Q4	Q4	Forecast	Forecast
KEY FORECASTS						
Turnover	1,361.9	1,634.7	2,038.9	2,545.7	2,976.0	3,297.3
%chg	▲20.0	▲20.0	▲24.7	▲24.9	▲16.9	▲10.8
EBIT	268.4	382.9	513.1	662.8	-	-
EBIT margin	19.7	23.4	25.2	26.0	-	-
EPS(p)	24.0	41.2	54.6	73.7	98.2	112.1
EPS % chg	▲57.3	▲71.9	▲32.3	▲35.1	▲33.3	▲14.2
DPS(p)	7.5	11.5	15.3	22.5	24.2	27.1
DPS % chg	▲114.3	▲53.3	▲32.6	▲47.5	▲7.6	▲12.0
Dividend cover	3.2	3.6	3.6	3.3	4.1	4.1

As long as the American economy holds up then I'd be inclined to agree. If President Trump is true to his word and implements a large programme of infrastructure spending then that should be very good for Ashtead's prospects.

I have to say that a ROCE of 16.7% for a rental company is impressive. My only slight quibble is that the company has to spend large amounts of money in order to grow. However, if that money invested is earning 16.7% then there's a lot to be happy about.

The shares trade on around 16.5 times April 2017 EPS estimates. That's not a bargain but is not too horrendous if earnings keep growing at an impressive rate. These shares could still do quite well with the caveat that they will probably suffer quite badly in times of economic weakness.

Filter of the week: Shares trading below earnings power value (EPV)

This week I am going to show you a favourite filter that I use when I am looking for very cheap shares. It's based on something called **Earnings power value** or **EPV** for short. EPV gives you the value of a share based on its current trading profits staying the same forever. To read more on the theory behind EPV **click here**. *This filter can only be done in SharePad.*

EPV per share Add criteria Exit

EPV ps (8%) % of Close Min: 100 Max: Edit

fc Norm EBIT > Norm EBIT Edit

No.	TIDM	Name	EPV ps (8%)	Close	EPV ps (8%) % of Close	Norm EBIT	fc Norm EBIT	fc Norm EBIT > Norm EBIT
1	BWY	Bellway PLC	4063.2	£24.54	166%	491.6	515.5	✔
2	BKG	Berkeley Group Holdings (The) PLC	3476.1	£29.06	120%	538.2	760.6	✔
3	BVS	Bovis Homes Group PLC	1256.5	833p	151%	165.3	193.1	✔
4	CMS	Communisis PLC	56.4	36p	157%	18.0	20.2	✔
5	CNCT	Connect Group PLC	172.0	140.5p	122%	58.6	69.3	✔
6	CSP	Countryside Properties PLC	234.2	230p	102%	106.9	155.9	✔
7	ETI	Enterprise Inns PLC	115.2	108.75p	106%	240.0	266.7	✔
8	GOG	Go-Ahead Group (The) PLC	3316.3	£21.53	154%	111.5	121.6	✔
9	INCH	Inchcape PLC	635.1	620p	102%	309.8	343.5	✔
10	INDV	Indivior PLC	334.4	295.9p	113%	254.5	331.4	✔
11	IAG	International Consolidated Airlines Group SA	609.4	434.7p	140%	1666.9	2234.4	✔
12	LOOK	Lookers PLC	170.8	115p	149%	89.7	94.0	✔
13	EMG	Man Group PLC	134.2	114.4p	117%	168.7	176.9	✔
14	MCS	McCarthy & Stone PLC	188.2	164p	115%	94.5	112.1	✔
15	NXR	Norcros PLC	183.8	180p	102%	19.2	23.6	✔
16	PSN	Persimmon PLC	2264.9	£17.29	131%	628.6	750.5	✔
17	PMO	Premier Oil PLC	148.1	62.5p	237%	226.1	251.3	✔
18	RDW	Redrow PLC	684.3	420.3p	163%	261.0	271.6	✔
19	RMG	Royal Mail Group PLC	650.3	473p	137%	323.0	565.0	✔
20	SBRY	Sainsbury (J) PLC	268.5	240.6p	112%	683.0	696.0	✔
21	SGC	Stagecoach Group PLC	280.3	211p	133%	179.6	187.2	✔
22	TW.	Taylor Wimpey PLC	198.4	153p	130%	636.6	746.0	✔
23	TPT	Topps Tiles PLC	90.7	84.75p	107%	21.1	24.5	✔
24	WIN	Wincanton PLC	305.6	231p	132%	46.4	48.7	✔
25	WIZZ	Wizz Air Holding PLC	2325.1	£18.26	127%	205.5	242.2	✔

Above is a filter that looks for shares trading below their EPV per share. This can happen because a company is going through a tough time and profits are expected to fall. To avoid these companies, I have asked SharePad to only pick companies where the forecast EBIT is expected to be higher than the last reported EBIT - in other words profits are expected to grow.

This has given me a list of 25 shares to look at. To help you narrow down your research further, try and find out what is happening to the key drivers of EPV:

- Are current profits sustainable or are they cyclical? E.g. house builders.
- Is debt or cash balances going up or down?
- Is there a rising or declining pension fund deficit?
- Is the company's tax rate increasing or decreasing?
- Is the number of shares increasing or decreasing?

Sometimes you will find lots of poor quality companies that you might be wary of. However, during times of market sell-offs it can be possible to buy decent quality companies for less than their EPV. This was true in 2003, 2009 and even after the EU referendum in June this year.