Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

16th December 2016

Market overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	6999.01	▲0.973	▲3.04	▲16.3	7097.5	5536.97	10/10/16	11/2/16
FTSE 250	17769.3	▲0.494	▲1.12	▲4.53	18342.1	14967.9	4/10/16	27/6/16
FTSE SmallCap	5050.62	▲1.25	▲3.03	▲12.4	5051.49	4145.59	10/10/16	12/2/16
FTSE AIM 100	3956.39	▲1.99	▲2.56	▲15.7	3993.45	3075.85	4/10/16	11/2/16
S&P 500	2253.28	▲0.316	▲3.34	▲10.3	2271.72	1829.08	13/12/16	11/2/16
UK Treasury 10 Year Par Yield	1.46	▲3.55	▲3.55	▼-25.1	2	0.61	30/12/15	12/8/16
Brent Oil Spot $	$53.72	▼-0.472	▲14.4	▲39.8	$55.435	$27.765	12/12/16	20/1/16
Gold Spot $ per oz	$1143.03	▼-2.36	▼-6.85	▲7.69	$1366.48	$1053.12	6/7/16	17/12/15
GBP/USD - US $ per £	1.23855	▼-1.58	▼-0.531	▼-17.7	1.50444	1.21697	15/12/15	27/10/16
GBP/EUR - Euros per £	1.19405	▲0.781	▲2.84	▼-13.2	1.3773	1.1066	16/12/15	13/10/16

The stock markets continue to rally and are finishing the year strongly. The major story, as it has been in recent weeks, is the continued slump in the price of gold.

Some commentators are speculating that gold might actually end the year down after performing so well up to the summer. Low interest rates are good for gold because investors are not losing much by holding it. Rising interest rates are bad for gold as cash and bonds become more attractive. The increase in US interest rates and the prediction of three further rate rises in 2017 has given the gold price a very good kicking this week.

Share Discussion: NCC Group (LSE:NCC)

Shares in cyber security company NCC Group have come crashing down since October. This company has been lauded by investors and some fund managers as a beacon of quality in an activity that is only likely to grow given how much business is done over the internet these days. Keeping data and systems secure is something that companies want to maintain at all costs and NCC exists to make sure that is the case for its customers.

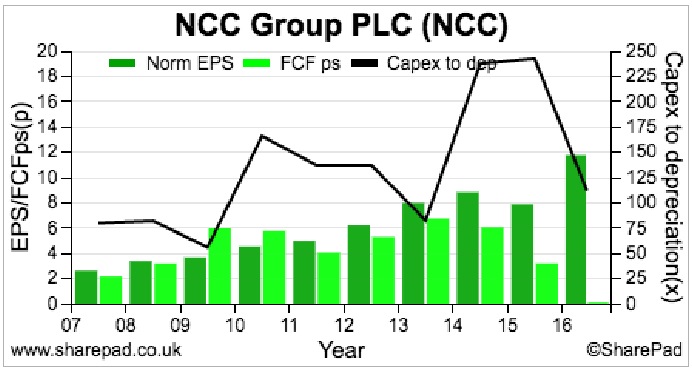
All seemed to be well until October this year when the company warned that three large contracts had been cancelled and that there were some issues with the retention of others. The shares tanked on the back of this news. This week, it quantified the effect on its profits for the year to May 2017 - EBITDA will only grow by 5% to between £45.5m and £47.5m.

This is very disappointing for a company where organic sales growth (excluding the impact of acquisitions) grew by 18% during the first half of the year. It is telling us that those cancelled contracts contained pretty chunky profit margins.

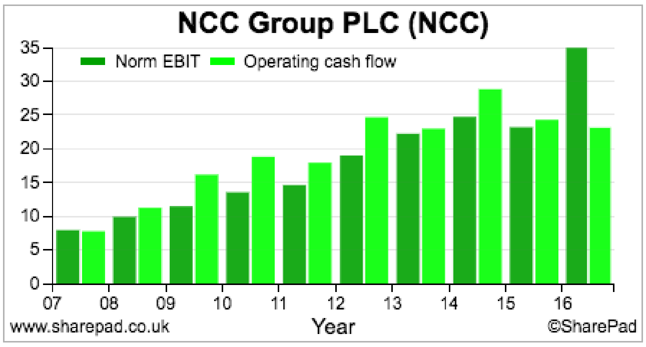
Also, EBITDA is not really profit, especially for a company which capitalises software development costs rather than fully expensing them against revenues. This is a common gripe amongst investors in software companies and one that I tend to share.

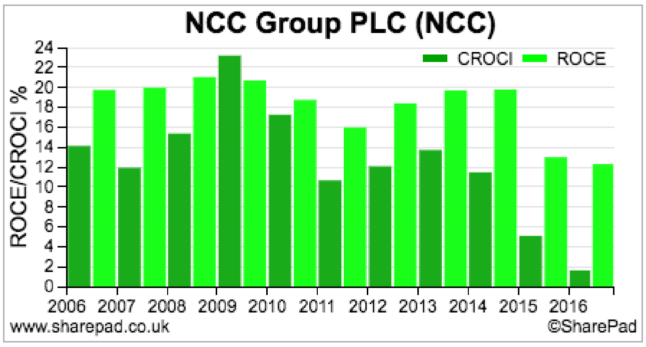
Spreading the cost of software development over a number of years makes a company look more profitable compared with a company that fully expenses all its costs in the year they occur. This approach is not illegal but it arguably means profits are stated less prudently.

When it comes to looking at most companies, and software companies are no different, my view is to pay particular attention to free cash flow. You want to see most of the company's profits turning into free cash. This has not happened at NCC since 2010 and there was a big gap between the two numbers in 2015.



What is also interesting is the trend in operating profit and operating cash flow.





There was a sharp increase in operating profit in 2016, but operating cash flow has fallen for two consecutive years and is at a similar level to 2013. I think it's entirely reasonable to suggest that NCC has a lot to do to improve its cash flow performance.

The other key sign that all is not well with NCC is that ROCE is on a downwards trend and that CROCI is poor. Following two big acquisitions in the last two years, I think that ROCE could fall further. Half year results released this week show very little profit growth, despite strong sales growth, and a sharp fall in profit margins.

NCC Group (£m)	H1 2016	H1 2015	% chg
Sales	125.8	93.5	34.55%
EBITDA	21.3	18.5	15.14%
Depreciation	-2.5	-1.6	56.25%
Amortisation of software & dev costs	-1.6	-0.5	220.00%
Adjusted EBIT	**17.2**	**16.4**	**4.88%**
EBITDA margin	16.93%	19.79%	
EBIT margin	**13.67%**	**17.54%**	

Are forecasts too high?

NCC Group PLC (NCC)

← Prev Next →		2015		2016	2017	2018	2019
Fiscal period ending		31/5/15	30/11/15	31/5/16	1/5/17	1/5/18	1/5/19
£ millions unless stated		Q4	Q2	Q4	Forecast	Forecast	Forecast
KEY FORECASTS							
Turnover		133.7	93.5	209.1	246.7	274.6	305.3
%chg		▲20.8	-	▲56.4	▲18.0	▲11.3	▲11.2
EBITDA		28.5	12.4	47.1	45.9	58.1	66.0
EBIT		23.2	8.6	35.0	-	-	-
EBIT margin		17.3	-	16.7	-	-	-
EPS(p)		7.9	4.4	11.8	10.7	13.0	14.7
EPS % chg		▼-10.8	-	▲49.2	▼-9.0	▲21.5	▲13.1
DPS(p)		4.0	4.2	4.7	5.2	5.7	6.2
DPS % chg		▲13.7	-	▲16.8	▲11.8	▲9.6	▲8.8
Dividend cover		2.0	-	2.5	2.1	2.3	2.4

I think there's a good chance that consensus profit forecasts will come down for 2017 and 2018. N+1 Singer updated its profit forecasts on 14th December and expects EPS of 9.8p for 2018, rising to 11.8p in 2018. That 2018 number looks quite challenging even with the help of acquisitions.

At 181p, the shares still trade on a very punchy 18.5 times 2017 forecast earnings. With issues surrounding its growth and cash flow performance, it might be a while before NCC shares start going up again.

That said, the chief executive who already has a sizeable stake in the company bought another 125,000 shares at 191p this week. It's always good to see management spending their own money to buy shares and with the chairman buying 50,000 shares as well that might be a positive sign on the long-term prospects of the company.

Share Discussion: boohoo.com (LSE:BOO)

Online fashion retailer boohoo.com has been a fantastic share to own in 2016. Its business is selling own brand fashion items to 16-24 year olds across the world at a value for money price point.

The company is currently growing at a rapid rate and is making decent profits at the same time. This week, the company increased its expectations of sales growth for the year to March 2017 of between 38-42% with an expected EBITDA margin of 11-12%.

This implies sales of between £270m-£277m compared with £195.4m in 2016 and EBITDA of between £29.7m (£270m x 11%) and £33.2m (£277m x 12%). On that basis, consensus forecasts could be too low. Even analysts who changed their forecasts on 14th December are below the top end of this range.

boohoo.com PLC (BOO)

Key	Name	Forecast	Confirmed	Opinion	Target price
	Investec Securities	5/12/16	5/12/16	Add	1.05
	N+1 Singer	28/9/16	14/12/16	Buy	1.10
	Panmure Gordon	28/9/16	14/12/16	Buy	1.14
	Peel Hunt LLP	1/12/16	9/12/16	Buy	1.40
	Shore Capital	28/10/16	9/12/16	Buy	
	Zeus Capital	14/12/16	14/12/16		
	Consensus	7/12/16		Buy (6) ℹ	1.17

ℹ The actual number of estimates used to calculate the consensus opinion

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Key	Name	Profit	EPS	Dividend	Turnover	EBIT	EBITDA
	Investec Securities	23.2	1.6		263.9		28.7
	N+1 Singer	25.0	1.7		263.9		29.3
	Panmure Gordon	28.6	1.9		264.0		29.9
	Peel Hunt LLP	26.2	1.8		267.9		31.1
	Shore Capital	25.0	1.8		261.1		
	Zeus Capital	27.1	1.9		280.4	25.6	
	Consensus	25.9	1.8		264.3	25.6	29.6

Boo.hoo has recently developed a habit of beating forecasts and seeing analysts subsequently upgrade forecasts again. This has been behind the company's sensational share price rise which might keep going for a while yet.

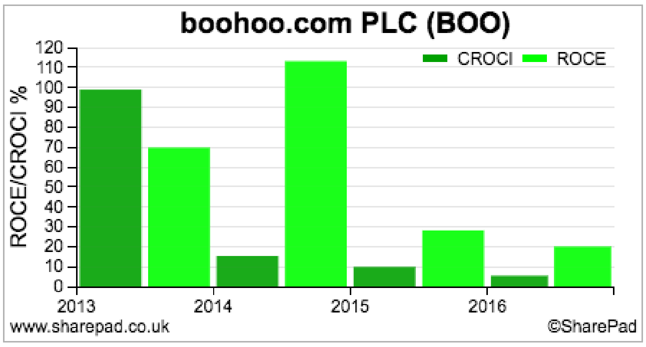
The company exercised its option to buy a competitor, Pretty Little Thing (PLT), on a cash-free, debt-free basis. This is a much smaller business than boo.hoo with revenues of £17m in 2016. However, it has been growing at a much faster rate with 150% revenue growth expected in 2017.

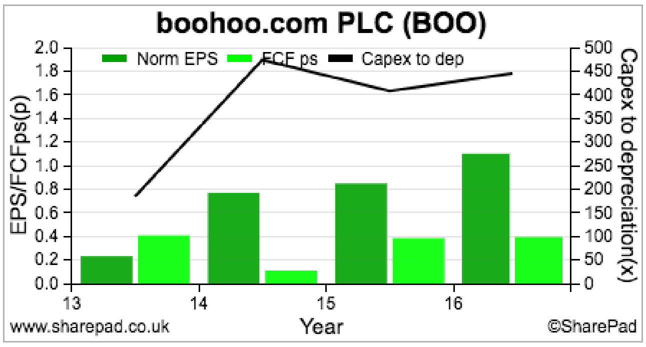
Pretty Little Thing is not yet profitable and is expected to be EBITDA breakeven in 2017. It's probably reasonable to expect that it will start adding to boohoo's profits in 2018.

Surprisingly, the company only bought 66% of the business with the remainder to be bought out in a few years' time. PLT's management team are staying on board. This seems a little strange to me, as I'd expect boohoo to integrate PLT into its own business as quickly as possible and start running it itself without the extra layer of management cost.

There's also a comment that PLT will grow at the same rate as boohoo from 2017 onwards. That implies a big slowdown in growth but that should be expected. Boohoo mentions that PLT will need extra warehousing to grow in the future.

Boohoo looks to be a very good business. Despite heavy investment, it had a lease-adjusted ROCE of 20% in 2016.





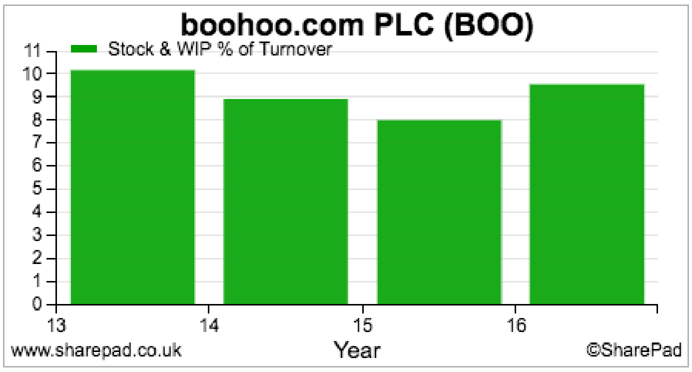
This is a lot lower than in 2014 but is still a very creditable number and one that many retailers would love. Given heavy investment it is not surprising that free cash flow per share lags EPS at the moment. Investors will want to see free cash flow improve in the future.

The real worry with a company that has been growing so fast is that it overextends itself. It can grow by extending too much credit to customers - who might not be able to pay - and might also take on too much stock which it has to discount at a later date, both of which hurt profits down the line.

Stock levels have been controlled well and have not been increasing as a percentage of sales.

Trade debtors have been increasing but they are such a tiny proportion of sales that there is nothing to worry about here. Boohoo's finances are in excellent shape with net cash in the bank.

The main issue facing investors in boohoo is that the shares are incredibly expensive. At 134p they trade on a 2017 PE of 74 times.



Companies have to grow profits at incredibly high rates for a long time to justify that kind of rating.

You can make a good case for saying that the potential for growth is significant, especially if overseas growth takes off. However, even though the company is not hindered by lots of high street shops, growth will still need significant investment in warehousing and logistics, IT and customer service.

The other issue is competition. What are the barriers to entry with this kind of business? What is there to stop another business entering the market and eating up boohoo's growth potential and profits.

Another thing to keep your eye on is the company's selling strategy. It slashed marketing expenditure from 12.6% of sales to 6.3% during the first half of the year which saved around £8m and might have boosted profits. The company opted to cut prices instead which reduced gross margins offsetting the marketing spend cut.

I can't work this out. Is the company having to cut prices to keep sales growth high and therefore cutting marketing costs to compensate? Or is it a different way of trying to grow sales?

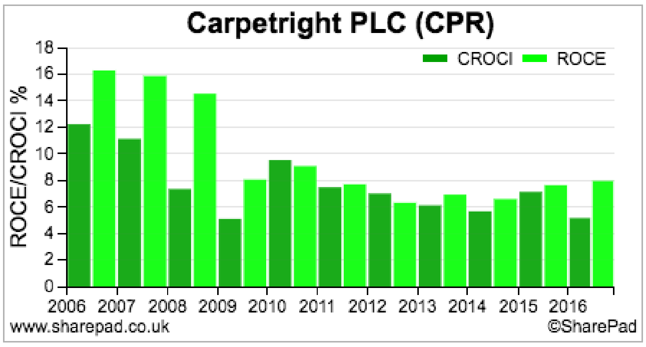
Finally, the impact of the fall in the value of the pound needs to be closely watched. This will push up the cost of imported clothes and might reduce profit margins.

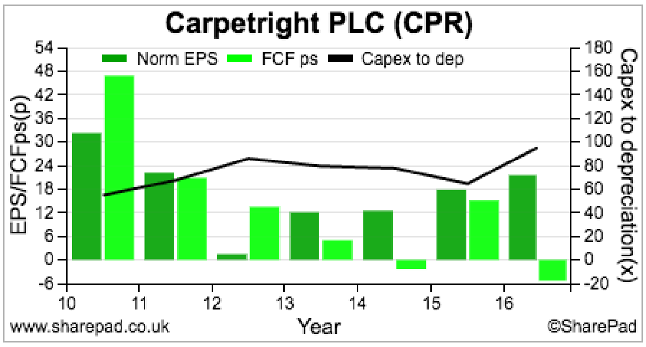
Share Discussion: Carpetright (LSE:CPR)

Retailing can be a hard slog. There's probably fewer harder markets to make money than selling carpets, floors and beds. These are the markets where Carpetright plies its trade. It is the biggest seller in Europe and times are tough. So tough in fact that Carpetright shares are close to lows not seen in twenty years.

If you are looking for quality companies to invest in then Carpetright is not going to be near the top of your list. Ever since the last recession it has failed to deliver anything close to reasonable returns on capital (ROCE).

What's even more worrying is that the company's cash flow performance has deteriorated even though profits have actually been growing for the last couple of years.





The company's biggest problem - apart from competition - is that it is saddled with the huge costs of running 429 stores in the UK and 137 in Europe. The high amount of fixed costs (costs that are not related to turnover) means that the company's profits are very sensitive to changes in sales (known as operational gearing).

This was seen in the company's half year results this week when 3.8% decline in sales led to a fall in pre-tax profit from £9m to £5m. The company mentioned that its markets were very competitive and that consumer demand was very variable.

However, there were some positives. Trading during the first six weeks of the second half of its financial year have started well with like-for-like sales increasing by 2.6% in the UK and by 5.9% in Europe. The company remains comfortable with 2017 consensus pre-tax profit forecasts of £16.1m.

The big risk with Carpetright remains the size of its rent bill relative to its trading profits. Fixed charge cover last year was only 1.2 times which is dangerously low. Thankfully, there are some opportunities to get the rent bill down with 40% of the UK stores up for a rent review during the next five years. In Europe there could be plenty of opportunities to reduce rents as the average length of rental is only 2.5 years.

Perhaps the biggest stumbling block to an upwards rerating of Carpetright shares is its poor free cash flow. Operating cash flow halved during the first half of the year, despite good stock control, and free cash flow was negative.

The shares are not particularly cheap on 10.7 times forecast earnings but unless those earnings can be converted into free cash flow then they are likely to appeal to only the hardiest of bargain hunters.

Filter of the week - a play on rising interest rates

Falling interest rates have caused a lot of problems. Not least for companies with final salary pension schemes. Low interest rates increase the cost of the promises to pay pensions - more money is needed at a lower rate to meet a fixed liability. This has seen pension deficits soar in recent years and take a toll on the share prices of many companies.

Interest rates now look as if they have bottomed and bond yields - which determine the present value of pension liabilities - are starting to rise. This is good news for companies with final salary pension schemes and their shareholders. Deficits could start coming down and give a nice boost to equity values and share prices.

On the following page is a filter from SharePad showing the companies with the biggest pension deficits as a percentage of their market capitalisation. These companies might be worth some more research to see if there is significant upside from a falling deficit if bond yields continue to rise.

FTSE All-Share sorted by Pension deficit % of Market Cap. (m) (625 items)					
No.	TIDM	Name	Pension deficit	Market Cap. (m)	**Pension deficit % of Market Cap. (m)**
1	TNI	Trinity Mirror PLC	-305.2	£241.7	-126%
2	HRG	Hogg Robinson Group PLC	-258.3	£210.3	-123%
3	RNO	Renold PLC	-82.8	£98.1	-84.4%
4	NXR	Norcros PLC	-55.7	£109.0	-51.1%
5	CMS	Communisis PLC	-41.1	£82.2	-50.1%
6	MTC	Mothercare PLC	-74.4	£189.7	-39.2%
7	CLLN	Carillion PLC	-393.5	£1021.9	-38.5%
8	WIN	Wincanton PLC	-105.6	£293.3	-36%
9	DLAR	De La Rue PLC	-219.9	£627.1	-35.1%
10	TCG	Thomas Cook Group PLC	-449.0	£1300.1	-34.5%
11	MAB	Mitchells & Butlers PLC	-291.0	£998.2	-29.2%
12	GKN	GKN PLC	-1594.0	£5476.0	-29.1%
13	CAR	Carclo PLC	-23.2	£92.5	-25.1%
14	MGAM	Morgan Advanced Materials PLC	-204.5	£829.9	-24.6%
15	BA.	BAE Systems PLC	-4501.0	£18705.0	-24.1%
16	CTR	Charles Taylor PLC	-39.6	£168.1	-23.5%
17	FGP	FirstGroup PLC	-270.9	£1232.9	-22%
18	DVO	Devro PLC	-56.4	£275.5	-20.5%
19	ATK	Atkins (W S) PLC	-285.8	£1496.8	-19.1%
20	TSCO	Tesco PLC	-3175.0	£16819.0	-18.9%
21	BT.A	BT Group PLC	-6382.0	£36211.6	-17.6%
22	AA.	AA Ltd	-296.0	£1686.1	-17.6%
23	FLYB	Flybe Group PLC	-15.3	£91.0	-16.8%
24	GNC	Greencore Group PLC	-162.3	£983.6	-16.5%
25	SIV	St Ives PLC	-26.4	£175.2	-15.1%