Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

5th January 2017

Market overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7195.31	▲1.05	▲6.65	▲17.2	7195.31	5536.97	5/1/17	11/2/16
FTSE 250	18308.2	▲1.55	▲4.85	▲6.41	18342.1	14967.9	4/10/16	27/6/16
FTSE SmallCap	5204.4	▲1.69	▲5.37	▲13.5	5204.4	4145.59	5/1/17	12/2/16
FTSE AIM 100	4127.28	▲1.69	▲5.8	▲18.3	4127.28	3075.85	5/1/17	11/2/16
S&P 500	2270.75	▲0.955	▲3	▲12.6	2271.72	1829.08	13/12/16	11/2/16
UK Treasury 10 Year Par Yield	1.37	▲9.6	▼-4.2	▼-27.5	1.89	0.61	5/1/16	12/8/16
Brent Oil Spot $	$56.47	▼-0.869	▲4.19	▲54.5	$56.965	$27.765	29/12/16	20/1/16
Gold Spot $ per oz	$1166.01	▲0.485	▼-0.361	▲8.19	$1366.48	$1077.03	6/7/16	14/1/16
GBP/USD - US $ per £	1.24183	▲1.09	▼-2.43	▼-15.4	1.47895	1.21697	22/6/16	27/10/16
GBP/EUR - Euros per £	1.1717	▲0.765	▼-0.98	▼-14.2	1.3651	1.1066	5/1/16	13/10/16

The start of the year is a time for predictions. I am not going to give any as I find them to be a pointless exercise. My advice for investors is to focus on stocks not markets and don't worry too much about the economy.

The only thing I will mention is to keep an eye on bond yields. Rising bond yields or interest rates influence the price of every financial asset. They work like a seesaw as when one end is up the other is down. Bond yields have been rising recently which may limit further upside in some shares (particularly expensive ones with high PE ratios) if inflation increases and central bankers raise interest rates to keep it in check.

All the best with your investing in 2017.

Share Discussion: Next (LSE:NXT)

It has been a very difficult year for Next shareholders. The company has rapidly moved from being a retail sector darling to something close to - but not quite - a sector dog. Its consistent track record of profits growth and the smart use of share buybacks which powered the shares over £80 has come to an end.

This week's all important Christmas trading statement made for pretty grim reading as sales at its high street stores fell by 3.5%.This was disappointing because the company was up against a weak sales performance from a year ago and it was expected to see growth.

Although sales at Next Directory were up by 5.1% and overseas stores' sales were up by 18% it was not enough to stop the company saying that profits would not grow in the year to January 2017.

Full Price Sales (VAT exclusive)	54 days to 24 Dec	Year to 24 Dec
NEXT Retail	- 3.5%	- 4.3%
NEXT Directory	+5.1%	+3.6%
NEXT Total	- 0.4%	- 1.1%
Of which sales from new space		1.4%

Even though stock levels were 3% lower than a year ago - which means less items to discount in the sales - post Christmas sales were down by 7% compared with a year ago.

Next's level of disclosure to investors is excellent and it always provides some very helpful guidance on what it thinks its profits will be for the year ahead. You don't really need to worry about what City analysts think. You can work out your own profit forecasts and simple valuation of the shares based on them. As the table on the right shows, its central guidance for earnings per share (EPS) is for it to be 0.6% less than last year.

Full Year Estimate	Central Guidance	Previous Guidance	
Year to January 2017 (52 week basis)		Lower	Upper
Total full price sales versus last year	- 1.0%	- 1.75%	+1.25%
Group profit before tax	GBP792m	GBP785m	GBP825m
Group profit before tax versus last year	- 3.6%	- 4.4%	+0.5%
Earnings per share growth versus last year	- 0.6%	- 1.3%	+3.7%

So with normalised EPS of 446.6p last year, that would give an estimate of January 2017 EPS of 443.9p. The lower end of the range would be 1.3% less at 440.8p. At a share price of £40.50 that would put the shares on a PE ratio of 9.1 times on the central estimate and 9.2 times on the lower estimate.

That's a low valuation for a business that was very recently seen as an example of retailing excellence. The problem is that things are set to get worse for Next in 2017.

The slowdown of sales of clothing and footwear has continued into January. Next's costs are also going up. The fall in the value of the pound is pushing up the cost of imported clothes, whilst wage costs and business rates are also going up.

This has led to a very downbeat forecast of sales and profits for 2017/18 as shown in the image on the right.

Sales and Profit Guidance Ranges 2017/18

The table below sets out our guidance range for sales and profits in the year ahead.

Full Year Estimate Year to January 2018	Lower	Upper
Total full price sales versus 2016/17 (at constant currency)	- 4.5%	+1.5%
Total full price sales versus 2016/17 (including currency gain)	- 3.5%	+2.5%
Group profit before tax	GBP680m	GBP780m
Change in profit before tax versus 2016/17	- 14%	- 2%

If we take a central forecast of 443.9p for 2016/17 and assume that EPS changes in line with changes in profit before tax then we are looking at EPS forecast of 435p at the upper end of the range and 381.8p at the lower end. At £40.50 per share, that would put Next on a forecast PE of between 10.6 times based on lower end forecasts and 9.3 times on the upper end.

The previous table above should serve as a warning to how sensitive Next's profits are to changes in sales. A 3.5% fall in sales is expected to lead to a 14% decrease in profit before tax. This is an example of significant operational gearing.

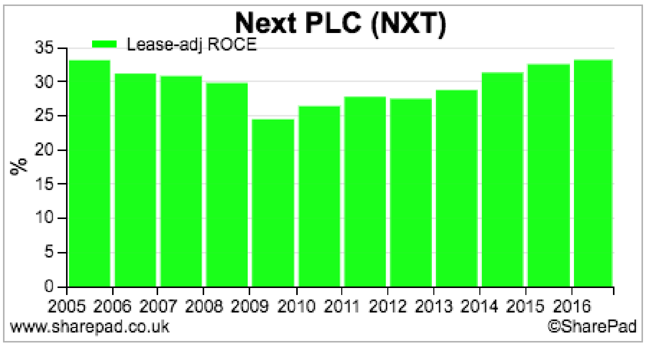
The company is still expecting to have lots of surplus cash flow and intends to pay four special dividends of 45p each during the next year on top of a regular dividend. Taking the consensus regular dividend per share forecast of 168.1p and 180p of special dividends, Next shares are offering a potential dividend yield of 8.6% which is sure to tempt income-seeking investors.

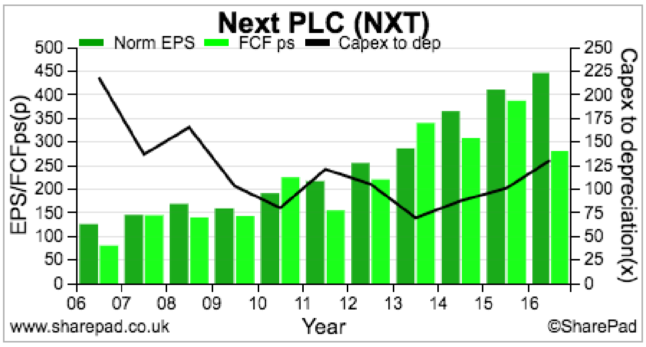
That said, I am slightly surprised that the company is not buying back its own shares with its surplus cash. The company has always used buybacks in preference to special dividends when it believed its shares were cheap and has been very good at not overpaying for its own shares. Given the very cheap valuation of Next shares at the moment, surely a buyback would make more sense? Is it a sign that management are not confident in the company's future profit potential?

Are Next shares a screaming buy?

Up until recently Next had many of the hallmarks of an outstanding business:

- It had been able to produce a consistently high and stable ROCE.
- And it had been able to turn a large chunk of its profits into free cash flow.





In my opinion, these two desirable characteristics alone are not enough to make an outstanding investment. You need a third factor - profits growth. This crucial element is what is missing from Next at the moment.

The problem Next is facing is that clothes shopping is moving more and more on to the internet and away from the high street. Whilst it has an excellent internet business in Next Directory, the competition in the form of companies such as Boohoo and Asos have caught up.

It may also be the case that people are spending less on fashion items in general. If inflation picks up as expected at a faster rate than wage growth then people are going to have less money to spend on everything. With Next looking as if it wants to maintain its profit margins then its products could also look expensive in the eyes of increasingly cash-strapped shoppers.

Next shares may bounce off their current depressed levels but until it can convince investors that its profits can start growing again, the yield is likely to remain the main attraction of the shares for a while.

Share Discussion: Persimmon (LSE:PSN)

Persimmon shares have bounced strongly since the EU referendum in June. However, the housebuilding sector has come under increasing scrutiny as to whether the favourable housing market backdrop which has existed since 2013 can keep on powering its profits upwards.

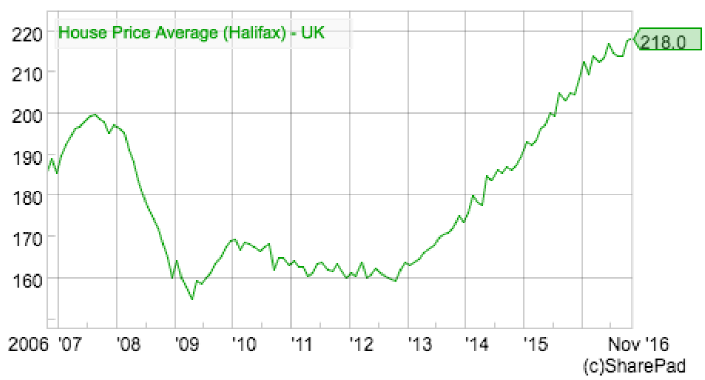
Thursday saw Persimmon release a very reassuring year-end trading update for 2016. It said that sales reservations in the autumn had been very strong. Sales for the year were up 8% split evenly between selling 4% more houses and selling prices increasing by 4%.

The company also said at the end of December that its forward sales were 12% ahead of last year and that its profit margins were also higher as it had kept a tight rein on costs. Cash balances have surged by over £300m during the year and were just over £900m at the end of December. Persimmon's finances are clearly in good shape.

Despite this, the company had very little to say about the outlook for 2017 other than mortgages are plentiful and houses are still affordable.

I remain very cautious on the housebuilders. The main reason being that they are not operating in a normal market. Housebuilders continue to be supported by the government's Help to Buy scheme which gives 20% equity loans on new build houses up to a value of £600,000 (40% up to £900,000 in London). This scheme has been in place since April 2013 and is due to end in 2021.

Without this support, my guess is that house prices would be a lot lower than they are now, builders would have sold fewer houses than they have done and their profits would be considerably lower. As you can see from the chart below, house prices were stagnating until Help to Buy was introduced in 2013.



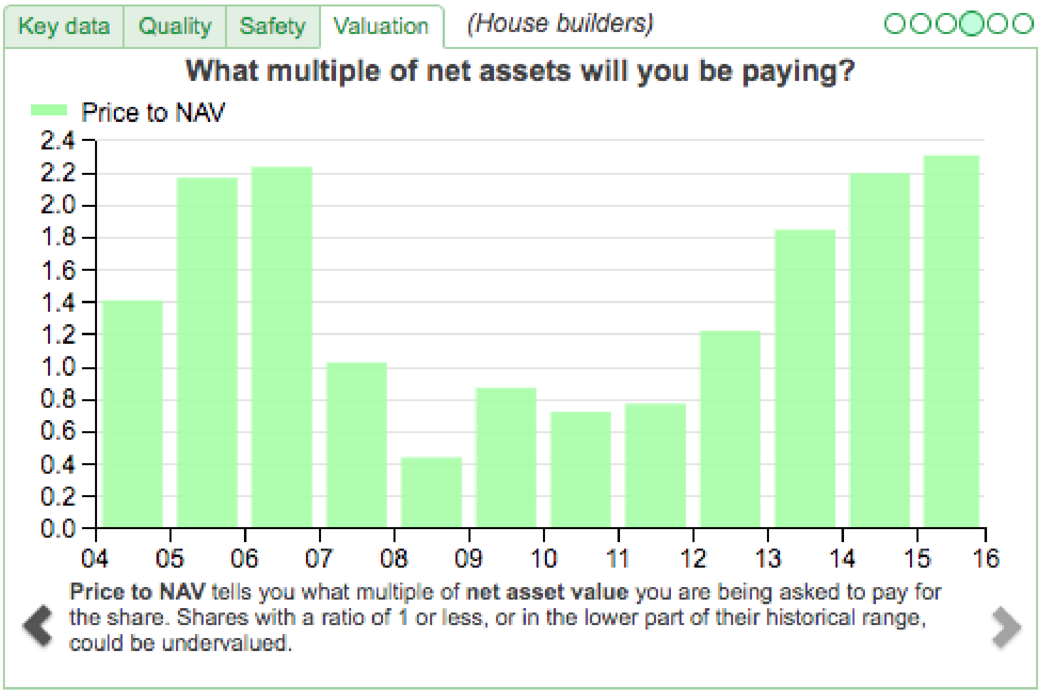
Persimmon is one of the major beneficiaries of Help to Buy which accounts for 4 in every 10 houses it sells. How will it fare when Help to Buy stops?

Elsewhere there are signs that the housing market is starting to cool down. Sales of £1m plus properties in London have fallen off a cliff and this will surely cool the London market and those in the south east of England. In my local area, I see signs of softness with new builds being reduced in price and incentives (such as help with paying stamp duty) increasing. A look at the Rightmove website shows houses staying unsold on the market for increasing amounts of time.

Then there is the valuation of Persimmon's shares. Its June net tangible asset value per share was 689p. At 1940p, this gives the shares a trailing P/NTAV multiple of 2.8 times. That is punchy.

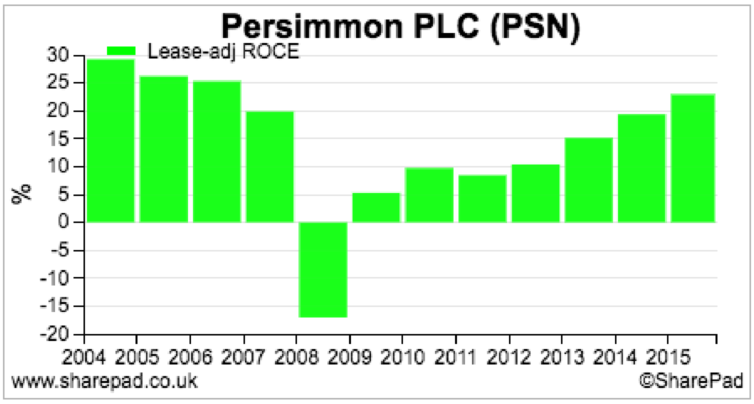
If we look at P/NAV, the shares are now at similar levels to the peak of the last boom in 2007. These shares are definitely not in the bargain basement.

Persimmon Historic P/NAV multiple



Profitability as measured by ROCE is also not far off the peaks of the last boom either.

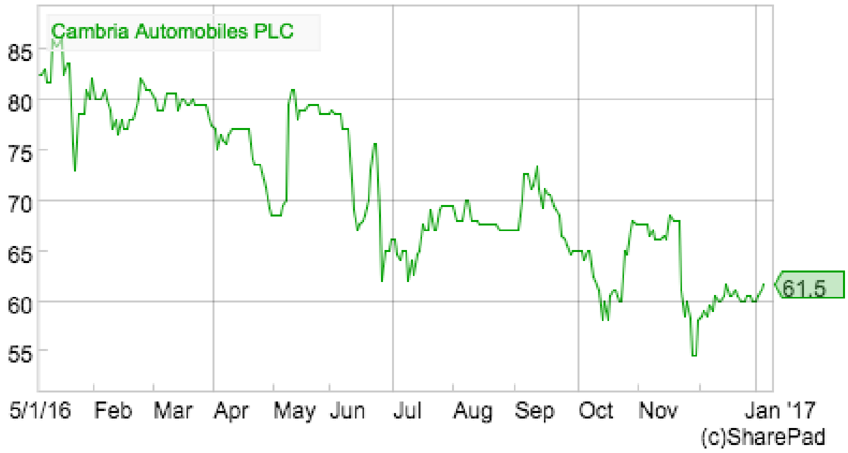
High profits - boosted by Help to Buy - and high valuations are suggesting that the good times are here to stay. History tells us that this rarely happens. Again, this is another sign that a lot of good news is priced into the shares.



The key attraction of the shares remains dividend income with the company paying out 110p per share for the next five years.

Share Discussion: Cambria Automobiles (LSE:CAMB)

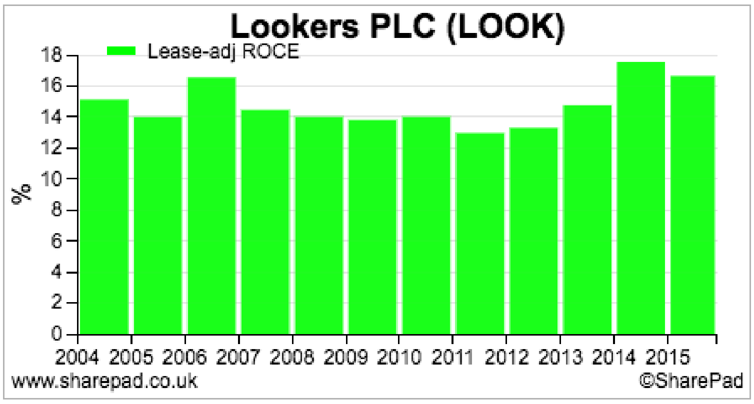
I think the car dealership sector could be one to keep an eye on in 2017. The sector is under a dark cloud at the moment. This is because it seems that the new car market has run out of steam - certainly with private car buyers anyway. Investors seem to think that the good times are over for car dealers but I am not so sure.



An AGM trading update from Cambria Automobiles this week confirmed that new car sales had turned soggy at its dealerships. First quarter new car sales were down 9.4% on a like-for-like basis, but used car sales were up by 3.6% and aftersales (servicing and spare parts) grew as well.

New car sales in the UK are expected to fall by around 5% in 2017. This is not surprising given the popularity of the credit-fuelled PCP (personal contract plan) in recent years where people increasingly rent rather than buy new cars.

However the growth in new car sales means that the used car market should continue to grow. Dealers often make more profit on used cars than new ones, whilst most cars will need regular servicing and repairs which also produce higher profit margins. The fortunes of car dealers and new car sales may not move in the same direction.



What I find interesting is that car dealerships seem to have been remarkably resilient businesses. Even during the last downturn, ROCE did not collapse at businesses such as Lookers for example.

Cash flow can be a bit of an issue as cash is eaten up financing stocks of cars but these businesses are prudently financed. Above all else, the shares in this sector look very cheap on a PE basis (see below). Consolidation is a regular feature in this sector with dealerships often snapping up rivals. Cost savings and extra profits may also cushion the current lower profits from new car sales. Could Cambria, with only a £60m market value, become a takeover target?

TIDM	Name	Market Cap. (intraday) (m)	Close	1 y low	fc PE	Lease-adj ROCE (7x, 7%)
CAMB	Cambria Automobiles PLC	£61.5	61p	54.5p	7.3	20.3
LOOK	Lookers PLC	£458.9	109.75p	92.5p	7.0	16.7
MMH	Marshall Motor Holdings PLC	£104.5	137.75p	133.5p	5.6	11.1
PDG	Pendragon PLC	£454.4	31.25p	26.71p	8.2	15.3
VTU	Vertu Motors PLC	£167.3	43.5p	37.75p	7.0	11.6

Filter of the week - How I invest

There are many ways to make money from the stock market. My approach is to focus on a long-term investment in quality businesses. My aim is to benefit from the high returns on capital that these companies make as they compound over time and hope that they are worth substantially more in ten or fifteen years from now.

I use SharePad to screen for candidates using the following criteria:

1. High and consistent returns on capital employed (ROCE). I look for a minimum lease-adjusted ROCE of at least 15% and a 10 year average ROCE of at least 15% as well. I want to invest in consistently good companies.

2. Profits that turn into cash. Average 10 year EPS conversion into free cash flow per share of at least 80%.

3. Capable of growing. EPS growth of at least 5%.

Filtered LSE Shares sorted by Name (28 matches)

ROCE vs PE Add criteria Exit

- [x] Lease-adjusted ROCE (7x, 7%) Min: 15 Max: Edit
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- [ ] forecast PE Min: Max: 20 Edit
- [x] Free cash conversion 10y average Min: 80 Max: Edit
- [x] forecast Normalised EPS change % Min: 5 Max: Edit

No.	TIDM	Name	Market Cap. (m)	Lease-adj ROCE (7x, 7%)	Lease-adj ROCE 10y avg (7x, 7%)	Free cash conversion 10y avg	fc Norm EPS %chg	fc PE	2y fc PE
1	888	888 Holdings PLC	£785.3	25.0	27.2	206.4	▲54.8	20.5	18.0
2	AVV	Aveva Group PLC	£1193.2	18.9	27.9	88.7	▲21.2	27.8	25.8
3	BJU	BrainJuicer Group PLC	£66.6	37.3	30.1	122.2	▲22.3	18.9	16.6
4	BRW	Brewin Dolphin Holdings...	£860.6	19.8	19.1	81.1	▲18.2	16.5	14.3
5	BRK	Brooks Macdonald Grou...	£266.2	19.4	27.4	105.6	▲8.4	17.8	15.0
6	CLIG	City of London Investme...	£92.7	47.1	65.0	98.0	▲39.4	10.7	8.5
7	CPG	Compass Group PLC	£24218.2	20.9	16.7	113.7	▲17.2	20.1	18.9
8	CRW	Craneware PLC	£357.2	27.0	28.1	109.8	▲21.6	36.2	32.6
9	DPLM	Diploma PLC	£1193.5	23.2	22.4	109.4	▲6.9	23.3	21.6
10	DOM	Domino's Pizza UK & IR...	£1864.7	32.7	25.2	86.5	▲13.5	26.7	24.0
11	FDSA	Fidessa Group PLC	£853.9	16.2	18.0	107.4	▲11.1	26.1	24.5
12	HL.	Hargreaves Lansdown P...	£6066.5	83.4	97.9	88.7	▲7.5	31.9	28.0
13	IGG	IG Group Holdings PLC	£1853.3	31.6	33.9	110.5	▲5.1	10.8	13.4
14	IHG	InterContinental Hotels ...	£7325.9	26.9	22.0	100.7	▲33.6	23.2	21.6
15	ITV	ITV PLC	£8107.2	40.2	17.7	96.2	▲8.9	12.4	12.6
16	KCOM	KCOM Group PLC	£475.3	26.3	19.1	88.3	▲18.7	13.0	16.1
17	MAI	Maintel Holdings PLC	£126.0	28.4	50.6	126.9	▲44.6	13.4	10.5
18	NICL	Nichols PLC	£613.0	38.0	36.7	80.7	▲8.3	25.5	23.8
19	PPB	Paddy Power Betfair PLC	£7341.3	33.8	32.9	111.4	▲72.4	26.5	21.9
20	PAY	PayPoint PLC	£700.3	49.6	49.0	105.6	▲5.7	16.3	15.5
21	RB.	Reckitt Benckiser Group ...	£47249.6	19.3	24.3	101.9	▲18.5	22.6	20.4
22	REL	RELX PLC	£30221.3	18.9	15.1	135.9	▲42.2	20.8	19.3
23	RNWH	Renew Holdings PLC	£279.8	26.1	20.9	104.4	▲42.3	14.1	13.3
24	RMV	Rightmove PLC	£3647.3	929.9	339.9	103.3	▲19.3	29.1	25.9
25	RWA	Robert Walters PLC	£262.5	15.4	16.2	120.3	▲15.9	15.1	13.6
26	ROR	Rotork PLC	£2166.5	18.9	40.4	92.9	▲12.0	26.2	24.7
27	RWS	RWS Holdings PLC	£758.4	22.6	25.3	90.0	▲31.9	28.3	27.0
28	SOM	Somero Enterprises Inc	£124.5	50.2	16.4	102.0	▲40.0	11.7	11.0

This gives me a list of shares to do more research on. The one crucial element I have left out here is valuation. You have to pay up for quality businesses but you mustn't overpay. That said, in recent times I have been putting far more emphasis on quality businesses over valuation as I think it is a bigger determinant of long-term investing success.

I am going to write a more detailed article on the subject of the price for quality companies next week. Keep your eyes peeled on your inboxes and the ShareScope website for more on this very important subject.

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