Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

3rd February 2017

Market overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7140.75	▼-0.29	▼-0.0291	▲20.6	7337.81	5536.97	13/1/17	11/2/16
FTSE 250	18259.2	▲0.642	▲1.01	▲12	18413.3	14967.9	10/1/17	27/6/16
FTSE SmallCap	5232.94	▼-0.0512	▲1.74	▲20.9	5274.5	4145.59	16/1/17	12/2/16
FTSE AIM 100	4271.27	▲2.44	▲4.92	▲31.1	4271.27	3075.85	2/2/17	11/2/16
S&P 500	2279.55	▼-0.746	▲1.82	▲19.8	2298.37	1829.08	25/1/17	11/2/16
UK Treasury 10 Year Par Yield	1.45	▼-5.84	▲14.2	▼-8.23	1.72	0.61	26/4/16	12/8/16
Brent Oil Spot $	$56.585	▲0.712	▼-0.3	▲74	$56.965	$30.81	29/12/16	9/2/16
Gold Spot $ per oz	$1209.79	▲1.8	▲5.15	▲7.3	$1366.48	$1127.52	6/7/16	2/2/16
GBP/USD - US $ per £	1.25383	▼-0.456	▲2.09	▼-13	1.47895	1.20401	22/6/16	16/1/17
GBP/EUR - Euros per £	1.1607	▼-1.55	▼-1.17	▼-12	1.3194	1.1066	2/2/16	13/10/16

A fairly quiet week on the markets. The one exception is the continuing strong performance of the AIM 100 index. It had another strong week and is significantly outperforming other UK indices.

The other notable move on the markets is the continued strength of gold, presumably on fears that inflation in the western world is likely to increase in the months ahead. Gold is significantly outperforming shares so far in 2017.

Top 10 FTSE All-Share winners

No.	TIDM	Name	%chg 1w
1	CPR	Carpetright PLC	▲20.5
2	CEY	Centamin PLC	▲16.7
3	KAZ	KAZ Minerals PLC	▲15
4	RPS	RPS Group PLC	▲13.4
5	BOK	Booker Group PLC	▲12.2
6	FXPO	Ferrexpo PLC	▲12.1
7	GNC	Greencore Group PLC	▲10.9
8	ACA	Acacia Mining PLC	▲10.7
9	SNN	Sanne Group PLC	▲9.73
10	GOCO	Gocompare.com Group PLC	▲9.49

Top 10 FTSE All-Share losers

No.	TIDM	Name	%chg 1w
1	WIZZ	Wizz Air Holding PLC	▼-14.7
2	ADN	Aberdeen Asset Management PLC	▼-9.17
3	PMO	Premier Oil PLC	▼-7.75
4	MLC	Millennium & Copthorne Hotels PLC	▼-7.12
5	CARR	Carr's Group PLC	▼-6.55
6	VP.	Vp PLC	▼-6.25
7	HGG	Henderson Group PLC	▼-6.24
8	EZJ	easyJet PLC	▼-6.03
9	CNE	Cairn Energy PLC	▼-5.62
10	TRS	Tarsus PLC	▼-5.58

My share discussions this week are focused on three companies that are currently struggling. I have chosen to do this because I believe that investors generally do not spend enough time trying to understand business risk.

Weak companies often see their shares trading at what appear to be bargain valuations. Sometimes they are but often they are cheap for a good reason and often get cheaper still.

Share Discussion: Vodafone (LSE:VOD) - is it a yield trap?

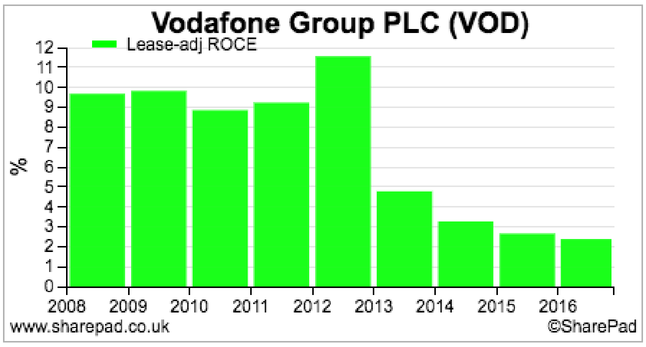
Vodafone's share price chart does not paint a pretty picture. Instead it paints one of a company that is having a hard time. This week's third quarter trading statement will have done nothing to change this view.

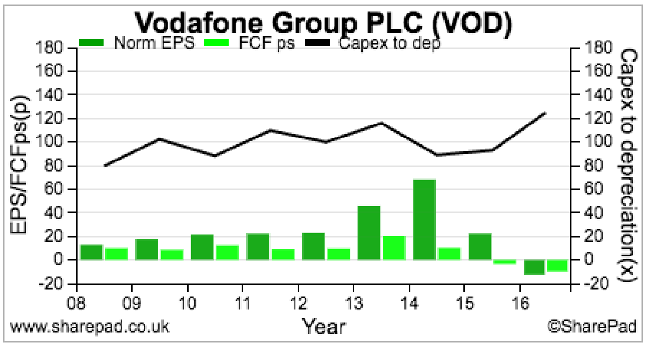
I am sure that many investors are attracted to Vodafone shares for two main reasons. Firstly, most people own a mobile phone and have a home broadband internet connection which makes the company easier to understand than many others. The second factor is the very big dividend yield which is currently forecast to be 6%.

These two factors alone are not good enough to warrant buying any share in my opinion. High yields are often a warning sign of a dividend that is at risk of being cut or where future dividend growth is likely to be low. High yielding shares are therefore often traps for the unwary investor. Could Vodafone be one of those shares?

Possibly yes. The company does not look particularly good on my two main tests of business quality - ROCE and free cash conversion.

Vodafone's ROCE has collapsed in recent years. Its lease-adjusted ROCE was 2.4% last year which is barely more than you can get on a savings account. This is a sign of poor quality business whilst the declining ROCE trend suggests that Vodafone's business is under a lot of pressure.

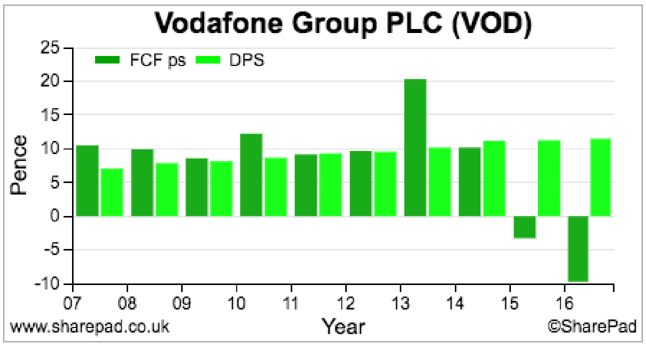




Free cash flow per share has been negative, whilst the company has not converted its profits into free cash flow for more than a decade. You can see from the black line in the chart above that Vodafone has hardly been on a spending spree either. Its spending on new assets (capex) has been broadly in line with depreciation which is usually helpful for converting profits into free cash flow.

Of more importance to income-seeking investors, there has been insufficient free cash flow to pay the dividend for the last three years.

Vodafone's problem is that it is operating in fiercely competitive markets. The price of mobile phone call plans has collapsed. In fact, for many personal customers it is cheaper to have a mobile phone plan than a landline.



Competition in the UK is very fierce as evidenced by Vodafone's third quarter average revenue per user (ARPU) declining by 3.2% as it cited a weak business market. However, a quick bit of research on the internet shows how expensive Vodafone's mobile calling plans are compared with BT's who are offering very cheap SIM only deals to their broadband customers.

For example, a BT SIM with unlimited minutes, unlimited texts and 15 gigabytes of 4G data is £20 per month if you are a BT broadband customer. Vodafone is offering a similar plan with slightly more data allowance for the same price but it is only on offer until March. This shows that the company is having to cut prices to compete.

Whilst business in Italy, Germany and Spain has stabilised there does not seem too much potential of future growth. In India - another important market for Vodafone - competition is intense with a new entrant being very aggressive on price.

Good businesses have pricing power and it seems that the mobile telecoms industry has little of it. The companies have to bear down on costs and/or offer bundles with home broadband and TV in order to compete. Vodafone has been late to the game in bundles, particularly in the UK.

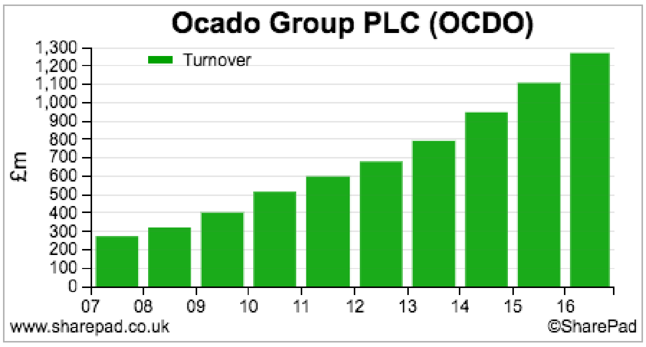
Vodafone Group PLC (VOD)

← Prev Next →	2013	2014	2015	2016	2017	2018
Fiscal period ending	31/3/13	31/3/14	31/3/15	31/3/16	1/3/17	1/3/18
£ millions unless stated	Q4	Q4	Q4	Q4	Forecast	Forecast
KEY FORECASTS						
Turnover	38,041.0	38,346.0	42,227.0	40,973.0	54,628.0	54,146.3
%chg	▼-18.0	▲0.8	▲10.1	▼-3.0	▲33.3	▼-0.9
EBITDA	12,135.0	10,531.0	11,582.0	11,375.0	15,523.0	15,702.4
EBIT	5,474.0	2,971.0	2,017.0	1,877.0	4,053.6	4,873.2
EBIT margin	14.4	7.7	4.8	4.6	7.4	9.0
EPS(p)	45.9	68.2	22.2	(12.4)	4.0	7.0
EPS % chg	▲100.5	▲48.4	▼-67.4	-	-	▲75.0
DPS(p)	10.2	11.2	11.2	11.5	11.6	12.1
DPS % chg	▲7.0	▲9.4	▲0.6	▲2.0	▲1.3	▲4.3
Dividend cover	4.5	6.1	2.0	-	0.3	0.6

Whilst the company is expected to make some profit progress through cost cutting, the shares at 192p are on 27 times 2018 forecast EPS, but more importantly the dividend is uncovered by profits. How long can the company sustain this?

Share Discussion: Ocado (LSE:OCDO) - waiting for a big deal

Online grocer Ocado is very well liked by its customers. By all accounts it is very good at looking after them. This has led it to win numerous online retailing awards and keep on growing its customer base and revenues at an impressive rate in recent years. 2016 was no exception as revenues increased by 14.8%.



A look at the company's key performance indicators (KPIs) show that most things are going well. It is gaining more customers and becoming more efficient at serving them.

The trouble is that despite all this positive momentum in its business Ocado cannot turn its growth in sales into the same growth in profit. Diluted EPS increased from 1.91p in 2015 to 1.96p in 2016.

What you want to see in a business which is growing its sales quickly is something known as operating leverage. In Ocado's case, this is where the fixed costs of all the upfront investment in technology and big fulfilment centres leverage its sales growth into an even higher rate of profits growth.

	FY 2016 (unaudited)	FY 2015 (unaudited)	Variance %
Average orders per week	230,000	195,000	17.9%
Average order size (GBP)(1)	108.10	111.15	(2.7)%
Mature CFC efficiency (units per hour)(2)	160	155	3.5%
Average deliveries per van per week (DPV/week)	176	166	6.3%
Average product wastage (% of revenue)(3)	0.7	0.7	-
Order accuracy (%)(4)	99.0	99.3	(0.3)
Delivery punctuality (%)	94.9	95.3	(0.4)

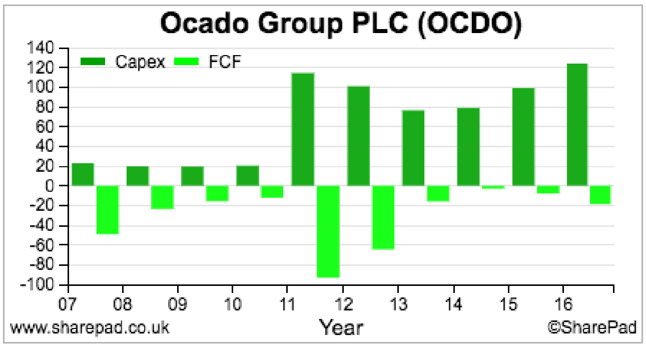
This is not happening. There are two good reasons for this. Firstly, Ocado is operating in a UK grocery market with intense levels of competition where prices have been falling (note its average order size fell by 2.7% in 2016).

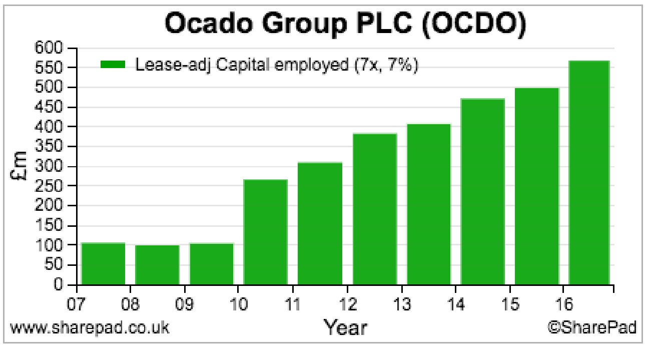
The other problem it has that it costs more money to deliver groceries to more customers. Distribution costs increased by 14.3% which is nearly the same rate as the growth in sales. This is largely what is stopping profits growing faster than sales.

Frankly, I am amazed that the supermarkets - even ones as efficient as Ocado - are making any money from online groceries. Profit margins are wafer thin and the revenues barely cover the cost of delivery. Delivery is incredibly inefficient with varying distances between households and problems such as congestion.

If that wasn't bad enough, Ocado is sinking huge amounts of money (capex) into its business in order to keep on growing. Capex increased in 2016 to over £150m and will be £175m in 2017. It begs the question as to when is this company going to generate any meaningful free cash flow? Most supermarkets don't.

The money invested in this business has been soaring and is now over £500m.





If Ocado was a moderately profitable business then it would be earning a return on that money (ROCE) of at least 10% or over £50m per year. This does not look like happening any time soon.

I've no idea what Ocado shares are worth but with a market capitalisation of £1.5bn and reported net profits of just £12m there is a lot of hope baked into the shares.

The big hope for the company and its shareholders is that it will strike a deal with big retailers to use its technology for their own online businesses. Ocado seems to have been talking to potential buyers for years but no company transforming deal has materialised.

Share Discussion: SSE (LSE:SSE) - slave to an unsustainable dividend policy?

If you are a shareholder in utility company SSE then there's only one thing that matters to you - the continuing growth of its dividend per share. This has become even more important in recent years as its share price has been very volatile but essentially gone nowhere.

The company makes its money from three main business areas:

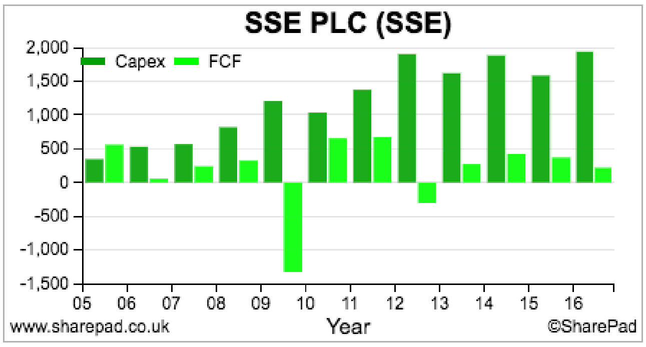
- Generating or producing electricity and gas.
- Transmitting and distributing electricity and gas via networks or grids.
- Selling electricity and gas to households and businesses.

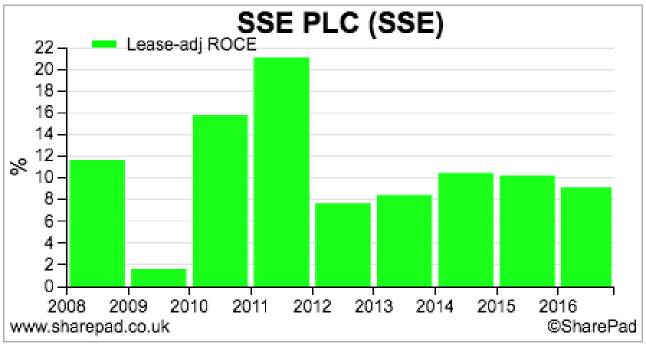
In my opinion it is the electricity and gas networks businesses that represent SSE's most valuable assets. These businesses have their prices regulated but significant investment and prices linked to inflation means that they produced rising trading profits and cash flows which in turn have underpinned SSE's rising dividend over the years.

Unfortunately, the other two businesses' fortunes are heavily influenced by prevailing wholesale gas and electricity prices. This has meant that they have not been a reliable source of sustainable and growing profits.

SSE has been pouring lots of money into new power stations, gas fields and networks over the last decade but I'm not convinced that it has paid off.

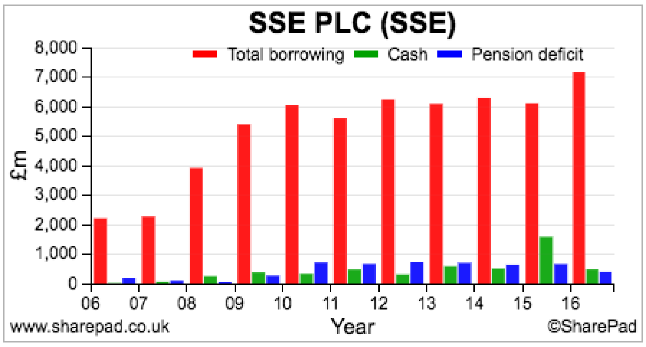
There has been no growth in free cash flow, whilst ROCE has been stuck at a very modest level.

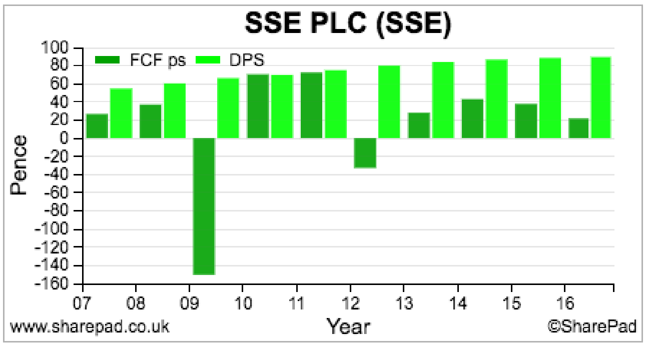




Most of the cash for new investment has come from increased borrowing.

However, as the declining ROCE chart signals above, this extra capex has not produced a significant uplift in profitability or free cash flow. At the same time, the dividend has continued to grow but has not been covered by free cash flow.





Does this mean that SSE's dividend is in danger of being cut? Not necessarily. One thing to note is that SSE has a sizeable scrip dividend where shareholders elect to receive their dividend in the form of new shares which saves the company some cash.

It is also important to acknowledge that this is not unusual for regulated utilities. The problem for outside investors is that it is quite hard - and time consuming - to work out how much the company is spending to stay in business (known as maintenance capex).

When I looked at the UK water companies back in 2015 (click here to read the analysis), I came to the conclusion that despite having dividends not covered by free cash flow they were not borrowing to pay their dividends. There was enough free cash flow after maintenance capex to pay them. They were borrowing to grow the size of their water networks. Given SSE's respected management team, my guess would be that they are doing the same thing.

TIDM	Name	Debt to OPCF	Debt / FCF	Interest cover	Debt/Total assets	fc Dividend cover
NG.	National Grid PLC	5.2802	28.316	3.7	48.1%	1.5
PNN	Pennon Group PLC	9.7144	-203.19	2.3	56%	1.2
SVT	Severn Trent PLC	6.4215	39.066	2.5	58.1%	1.3
SSE	SSE PLC	3.1018	32.779	4.5	32.3%	1.2
UU.	United Utilities Group PLC	8.1863	-690.89	3.6	58.6%	1.1

Another plus for SSE is that it appears to have the lowest debt ratios of the quoted UK network utilities.

The company has promised to keep on increasing its dividend in line with RPI inflation and will probably do so until the next regulatory review of its electricity and gas network assets in 2020/21.

That said, the business does face some risks. If the regulator forces SSE to cut prices then this could put pressure on the dividend. The other thing to be aware of is that SSE's power generation business is made up of a significant number of wind turbines. Its wind farms currently receive a subsidy in order to make them economically viable. If those subsidies were to be cut then SSE's cash flow could fall and put pressure on the dividend payment.

This concern around the dividend largely explains why SSE's share price has made little progress in recent years. The forecast yield of 6.2% is based on expected rates of dividend growth of 2.0%. Add these two numbers together and you get an expected investment return of 8.2%. That's alright if the dividend is safe but dividend cover is already thin at 1.2 times and doubts about dividend sustainability are unlikely to go away. It would not surprise me if SSE's share price continued to tread water.

Filter of the week - searching for quality and safety in the retail sector

Retailing is a difficult sector for long-term buy and hold investors. The reason for this is that very few have formats that can deliver sustainable profits growth. I see retailing as a great sector for traders but you need to pay attention to the kind of shares you are buying.

You need to be careful with retailers because many of them tend to be financed with rented assets and therefore have lots of hidden debts. You need to adjust for these when screening for retail shares.

Fortunately, SharePad can help you with this.

I see three key characteristics which can contribute towards a successful retail share trade.

1. A high quality business with a lease adjusted return on capital (ROCE) of at least 15%. If you don't adjust for leased or rented assets then you will make the mistake of thinking companies are earning more impressive returns than they are in reality.
2. Safe businesses - the ability to pay the rents on shops and interest on debt. Companies with fixed charge cover of more than 2 times would satisfy this criteria.
3. Continued growth - look for forecast EPS growth of at least 10%.

Here is a list of shares which meet this criteria:

This filter has focused on quality, safety and growth. I'll leave you to work out if any of the qualifying shares are good enough value to buy.

This newsletter is for educational purposes only. It is not a recommendation to buy or sell shares or other investments. Do your own research before buying or selling any investment or seek professional financial advice.

Filtered LSE Shares sorted by Name (5 matches)

QuickFilter — Add criteria | Keep | Exit

- Sector includes **General Retailers**
- Lease-adjusted ROCE (7x, 7%) Min: 15 Max:
- Fxd charge cover Min: 2 Max:
- forecast Normalised EPS change % Min: 10 Max:

No.	TIDM	Name	Lease-adj ROCE (7x, 7%)	Fxd charge cover	fc Norm EPS %chg	fc PE
1	ASC	ASOS PLC	23.3	7.6	▲13.0	68.8
2	BOO	boohoo.com PLC	20.0	11.8	▲90.9	66.1
3	INCH	Inchcape PLC	15.5	4.5	▲11.5	12.9
4	JD.	JD Sports Fashion PLC	16.8	2.2	▲37.6	19.9
5	SFE	SafeStyle UK Ltd	31.5	5.4	▲15.6	14.4