Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

10th February 2017

Market overview

TIDM	Name	Price	%chg 1w	%chg 1m	%chg 1y	1 y high	1 y low	Date 1 y high	Date 1 y low
UKX	FTSE 100	7235.15	▲1.32	▼-0.0362	▲28.5	7337.81	5536.97	13/1/17	11/2/16
MCX	FTSE 250	18629.3	▲2.03	▲1.36	▲21.6	18629.3	14967.9	9/2/17	27/6/16
SMX	FTSE SmallCap	5296.68	▲1.22	▲0.935	▲26.7	5296.68	4145.59	9/2/17	12/2/16
AIM1	FTSE AIM 100	4316.75	▲1.16	▲3.82	▲39	4325.04	3075.85	7/2/17	11/2/16
GSPC	S&P 500	2308.88	▲1.23	▲1.76	▲24.7	2308.88	1829.08	9/2/17	11/2/16
UKTP...	UK Treasury 10 Year Par Yield	1.34	▼-5.63	▼-2.9	▼-7.59	1.72	0.61	26/4/16	12/8/16
BR$SP	Brent Oil Spot $	$55.515	▼-2.18	▲1.3	▲80.2	$56.965	$30.81	29/12/16	9/2/16
G$SP	Gold Spot $ per oz	$1234....	▲1.64	▲4.4	▲3.81	$1366.48	$1128...	6/7/16	15/12/16
GBP...	GBP/USD - US $ per £	1.25364	▲0.137	▲3	▼-13.3	1.47895	1.20401	22/6/16	16/1/17
GBP...	GBP/EUR - Euros per £	1.1753	▲1.03	▲2.23	▼-8.26	1.3174	1.1066	25/5/16	13/10/16

The stock markets have been strong this week. From my own portfolio's point of view I can't help feeling that some shares are going up a bit too much without any fundamental reasons to explain it. Investors in general seem quite happy to keep on buying shares.

Just like the start of 2016, gold is outperforming shares. Gold tends to do well when shares are doing badly so I am not sure I can explain what's going on here, other than continued worries about rising inflation.

The pound has made a decent gain against the euro and continues to improve against the US dollar. Some investing commentators that I listen to feel that the dollar is overvalued and is due a correction. This means you need to keep a close eye on the £/$ exchange rate as the falling pound has provided a boost to the profits of companies with large overseas earnings. This could be reversed if the pound continues to gain ground.

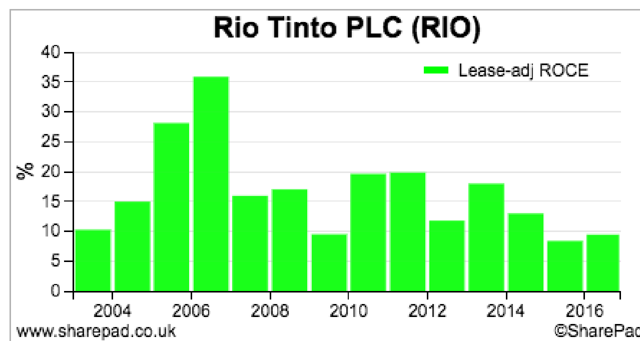
Share Discussion: Rio Tinto (LSE:RIO)

Investing in shares of mining companies is very hard for long-term buy and hold investors. Their profits are extremely sensitive to the ups and downs of the economic cycle which can make them seem hugely profitably when times are good and appear very weak and vulnerable when times are bad.

Their share prices are also very volatile as they move up and down on news about the economy and changes in commodity prices. I see the big mining shares such as Rio Tinto as trading stocks. You can make good money in them if you get your timing right but it is unlikely to be a smooth ride.

Rio Tinto shares have been on a storming run over the last year as commodity prices have

recovered and profitability has started to improve. Yet, the company is nowhere near as profitable as it was during its heyday around a decade ago as shown in the chart below-right.



ROCE has plummeted since then and has moved up and down a lot. But could we be at the beginning of a sustained upturn in profitability and ROCE which could mean that Rio's share price rally has further to run?

I'm not too sure about that mainly because trying to call the outlook for the economy and commodity prices is virtually impossible. However, Rio's 2016 results which were released this week do give some grounds for optimism.

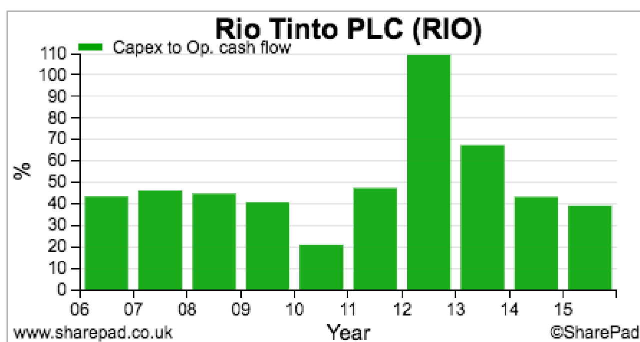
Profits and cash flow were up, driven by a 17% increase in profits from the core iron ore business and a recovery in coal profits. The company has also taken out a lot of costs which allowed it to increase its profit margins despite lower average commodity prices throughout the year.

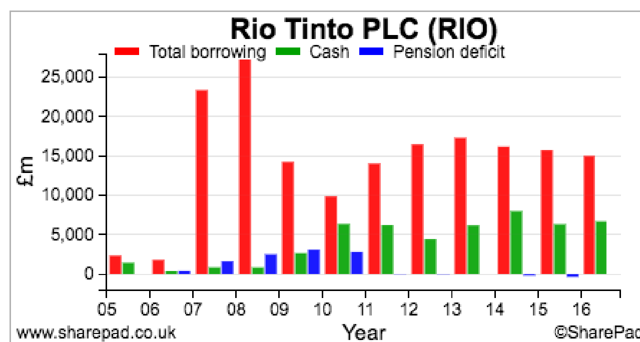
The big story of the results release was all about the company's free cash flow.

In recent years many mining companies have embarked on huge capital expenditure (capex) programmes - spending money on new projects. Rio is no exception in this respect but as the ROCE chart above shows this spending has not really paid off.

Rio had been ploughing back a large chunk of its operating cash flow into new assets, but its capex ratio has been coming down and did so again in 2016.

Capex was cut by 36% in 2016 and net debt fell by 30% in US dollar terms (less so in sterling due to the appreciation of the dollar against sterling).





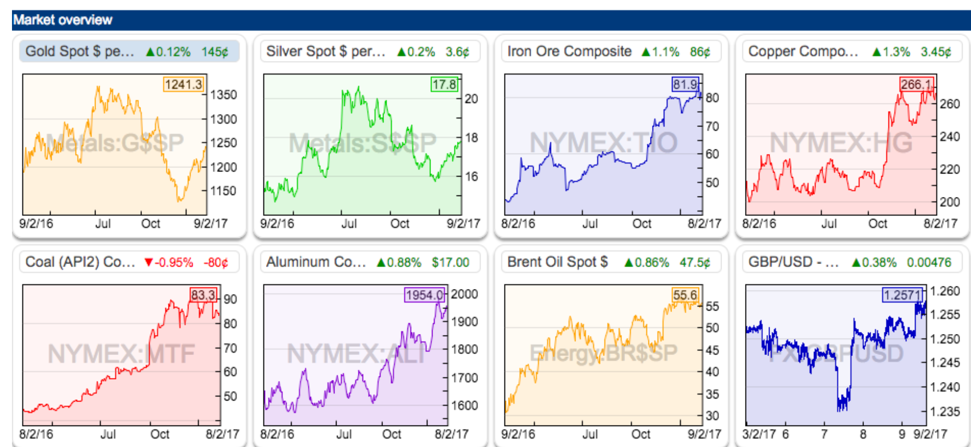
This progress of cash flow and debt saw Rio surprise investors by announcing a much bigger dividend than expected ($170 cents per share) as well as a $500m share buyback. The company reckons that there is more progress to be made on cash generation.

What's encouraging is that the company is prioritising profitability over volume growth. It reckons it can take out another $2bn of costs and improve free cash flow by $5bn over the next five years. I think this is sensible and it takes away some of the risks that come with investing in big mining projects - although the company still has new projects to come into production.

Trying to predict future profits for mining companies is notoriously difficult. It's even more so for UK investors as you have to take a view on what the GBP/USD exchange rate will be. On a forecast PE of around 12 and a dividend yield of over 4% the shares do not look overly expensive given that profits and cash flows are expected to improve in 2017 with big improvements in free cash flow over the next five years.

That said, my view is that shares such as Rio are best suited to momentum and trading strategies. If you are going to go down this route then it will be helpful to keep an eye on changes in commodity prices and exchange rates as these have a big influence on sentiment and short-term share prices.

You can do this very easily in ShareScope and SharePad. My favourite way is to set up charts on the Market Overview page in SharePad. One for commodities is shown on the right.



Share Discussion: Redrow (LSE:RDW)

Half year results from housebuilder Redrow can be summed up in one word: stunning. In fact, if you wanted to see a company where profits were growing, ROCE was high and growing and debt was low then Redrow would be a very good example to use.

These results were new records for the company. Sales increased by 22.6%, trading profits (EBIT) were up by 30.9% and operating margins increased from 18.2% to 19.5%. Equally impressive was the outlook which was underpinned by an order book that is 35% higher than a year ago.

In fact, Redrow is so confident about the future that it has given a forecast for the year to June 2019 already - nearly two and half years away. It is predicting:

- Sales of £1.9bn
- Profit margin of 19.5%
- EBIT of £370.5m
- EPS of 77p

This compares with its 2016 results:

- Sales of £1.38bn
- Profit margin of 18.9%
- EBIT £261m
- EPS 55.2p

At the current share price of 471p, Redrow would have a PE on 2019 forecast EPS of just 6.1 times. To the uninformed this would have to make Redrow shares one of the biggest bargains on the stock market. They could well be but housebulding shares often look at their best just before things turn sour.

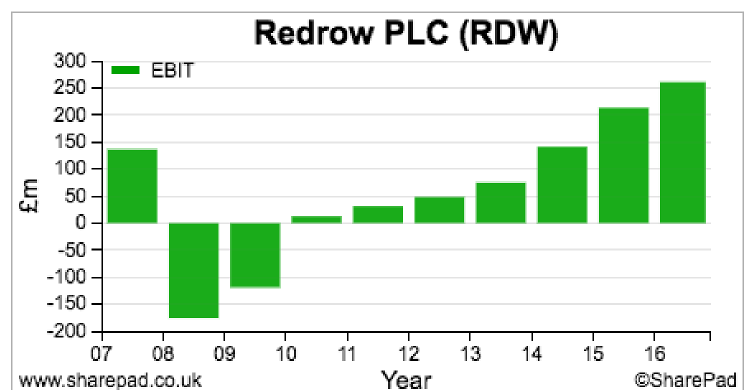
Those of you who follow my twitter feed (@PhilJOakley) will know that I have grave reservations about the state of the UK housing market. In short, I think it is something of a false market. I see houses as being vastly overpriced relative to measures such as wages or rents.

The demand for houses is also being underpinned by the government's Help to Buy scheme where buyers are given a 20% equity loan by the government on properties up to a price of £600,000. The size of the equity loan in London is up to 40%.

Ask yourself why Help to Buy exists in the first place?

It is because properties are so expensive that banks and building societies will not allow buyers to have 95% loan to value mortgages as they are scared that if house prices fall the value of the mortgage will be more than the value of the property (negative equity). This is why house prices and the housing market stagnated after the recession of 2008/09.

So in 2013, the government introduced Help to Buy which protected the banks from the risk of falling house prices. They then started lending and people started buying houses with 5% deposits again. The result was that house prices have rocketed and so have the profits of the housebuilders.



Unsurprisingly, the housebuilders like Help to Buy and now seem to be very reliant on it. It accounts for around one third of Redrow's sales and over 40% for builders such as Persimmon.

If you are an investor in a house building company then ask yourself what selling prices and sales volumes would be without Help to Buy? My guess is that they would be lower, as would profits and share prices.

The good news for investors is that the government is currently committed to Help to Buy until 2021 so the market for new build properties is going to be propped up for a while yet it would seem. However, with house prices for family homes in the south of England (where Redrow has 40% of its land bank) already pushing over the £600,000 mark, it is possible that the effect of Help to Buy in some areas could begin to wear off.

In and around Chelmsford in Essex where I live, I can see signs that the housing market is slowing down. Family houses are staying unsold for months as vendors refuse to reduce their asking prices. The new build market is slowing down too with prices being cut on new developments.

A closer look at Redrow's interim results presentation also reveals an interesting fact. The number of private houses sold only increased by 2%. Is this a blip or the start of a trend?

Turnover growth of 12% from private houses was largely down to a 10% increase in average selling prices. What happens to sales and profits if house prices stop rising or even fall?

Redrow's volume growth is coming from apartments where there has been a huge increase in the numbers sold and a big increase in the average selling price. But apartments are still quite a small part of Redrow's business. Is it now reliant on apartments to meet its profit forecasts?

Homes Turnover Analysis

- Record Homes first half revenue of £733m, up 26%
- Legal completions up 13% to 2,459 including JV
- Apartments were 17% of private sales turnover (2016: <8%)
- ASP on private houses up 10% to £337k due to mix and HPI
- Overall private ASP up 12% to £344k due primarily to mix and HPI

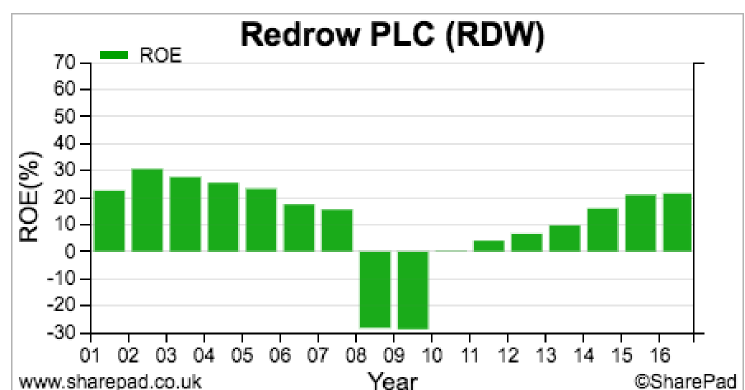
	Turnover (£m)				Volume				ASP (£k)			
	H1 17	H1 16	Var	% Var	**H1 17**	H1 16	Var	% Var	**H1 17**	H1 16	Var	% Var
Private Houses	**569**	506	63	12	**1,689**	1,660	29	2	**337**	305	32	10
Private Apartments	**118**	42	76	181	**309**	131	178	136	**382**	320	62	19
Total Private	**687**	548	139	25	**1,998**	1,791	207	12	**344**	306	38	12
Social	**46**	36	10	28	**418**	387	31	8	**110**	93	17	18
Total Homes	**733**	584	149	26	**2,416**	2,178	238	11	**303**	268	35	13

As long as the economy keeps growing, interest rates stay low and Help to Buy stays in place then Redrow's profits are unlikely to fall. That said, I think there are grounds for caution for Redrow and the industry as a whole.

The stock market seems to agree. A company in a less cyclical industry with a financial performance as good as Redrow's would be trading on a PE ratio of more than 20 times in the current market not one of less than 9.

At 471p, the shares trade on 1.6 times December 2016 net asset value (NAV) per share. This does not look expensive for a company where return on equity (ROE) was 21% in 2016 and is expected to rise to 24% in 2019. However, this is only true if the ROE can be sustainably high. History suggests that it will not.

Redrow is obviously performing well and could continue to do so for some time but I would feel more comfortable if it was operating in a normal housing market and not one reliant on lots of support for buyers.

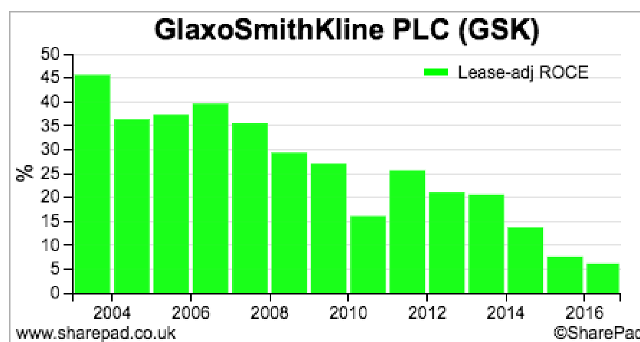


Share Discussion: GlaxoSmithKline (LSE:GSK)

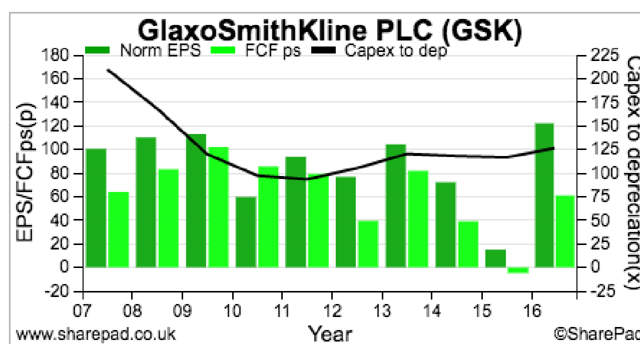
GSK has been a mainstay of many investors' portfolios for years. It has been held up as an example of a high quality business and is liked for its high dividend yield.

However in recent years the company has been struggling to make headway as it has faced a number of challenges. From a financial analysis point of view, I see three areas for concern:

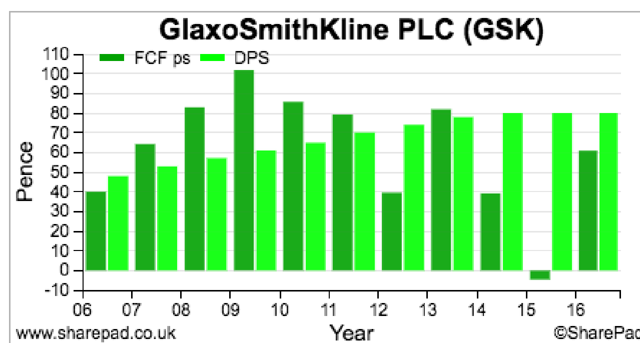
1. ROCE has collapsed in recent years from being a very good number to a very poor one.
2. The company has struggled to turn its profits into free cash flow.
3. Free cash flow per share has not been sufficient to pay the dividend per share.



Despite this backdrop, the company is actually doing a good job of trying to get back on track. Full year results for 2016 were pretty decent to say the least with good growth across its Pharmaceutical, Vaccines and Consumer Healthcare businesses. It was also helped by the fall in the value of the pound as profits made overseas received a nice boost when they were translated back into pounds.



What is very encouraging is that sales growth from GSK's new products in areas such as HIV, oncology and vaccines seem to have offset declines in its existing portfolio of drugs. The company is spending more than 12% of its sales on research and development to create new money-making products for the years ahead.



However, it would be wrong to say that GSK is back on the front foot. It still faces two big problems. The first one is that some very profitable drugs - such as asthma drug Advair - are due to come off patent soon and will be opened up to competition.

The company has flagged this as a big risk to its 2017 EPS forecast. If a generic competitor is released into the US market in 2016, the company has said that its EPS at constant exchange rate could be flat to slightly down. If there is no competition then EPS could increase by 5-7%.

The other problem is that governments - who are the main buyers of GSK's drugs - are strapped for cash and are putting pressure on GSK to reduce its prices. This is unlikely to change in the future and could make it hard for GSK to improve its profits, cash flows and ROCE.

The company is likely to get some breathing space from the weakness of the pound in 2017 - although this does increase the value of debts which are denominated in overseas currencies. Based on January's exchange rates, this would boost GSK's 2017 EPS by 9%.

GSK shares have struggled to make much progress over the last decade but shareholders have pocketed some decent dividend payments by way of compensation. Given that the shares are on a forward PE of just over 15 with a yield of 5.1% I don't see 2017 being much different.

Filter of the week - Combining dividend yield with dividend growth

Many people invest for income. This can lead them to seek shares with very high dividend yields so that they can get the biggest bang for their buck. This can lead to problems as high yields can be a sign of a company with an unsustainable dividend or one that isn't expected to grow that much in the future.

It can often be a better approach to select shares with lower yields but with strong dividend growth prospects. This can lead you to have higher dividend income over the long run and may see you make capital gains as well as the stock market places a higher value on the company's dividend stream.

The filter below has three criteria.

- Current dividend yield of at least 3%
- Forecast dividend growth of at least 10%
- Forecast dividend cover of at least 1.5 times

dividend growth — Add criteria | Exit

- Yield — Min: 3 — Max:
- forecast Dividend per share 1y change % (annualised) adjusted ... Min: 10 — Max:
- forecast Dividend cover — Min: 1.5 — Max:

No.	TIDM	Name	Yield	fc Dividend per share 1y %chg (ann) Adj	fc Dividend cover
1	GFRD	Galliford Try PLC	5.6	▲17.2	1.6
2	CRST	Crest Nicholson Holding...	5.2	▲26.1	1.9
3	PFC	Petrofac Ltd	5.0	▲18.1	1.8
4	TNI	Trinity Mirror PLC	4.8	▲16.5	6.1
5	CMCX	CMC Markets PLC	4.7	▲53.0	2.0
6	BVS	Bovis Homes Group PLC	4.7	▲11.8	2.2
7	TUI	TUI AG	4.7	▲17.4	1.6
8	OML	Old Mutual PLC	4.3	▲13.5	2.2
9	AV.	Aviva PLC	4.2	▲10.1	2.2
10	KWE	Kennedy Wilson Europe ...	4.1	▲22.5	3.5
11	RIO	Rio Tinto PLC	4.0	▲11.7	1.8
12	ESUR	esure Group PLC	3.9	▲15.9	1.9
13	NXR	Norcros PLC	3.9	▲15.2	3.4
14	SAGA	Saga PLC	3.9	▲19.4	1.6
15	BDEV	Barratt Developments PLC	3.6	▲95.6	1.5
16	SUS	S & U PLC	3.5	▲18.4	1.9
17	MGNS	Morgan Sindall PLC	3.5	▲10.3	2.4
18	LLOY	Lloyds Banking Group PLC	3.4	▲42.2	2.1
19	DFS	DFS Furniture PLC	3.2	▲50.7	2.1
20	RNK	Rank Group (The) PLC	3.2	▲10.8	2.1
21	DC.	Dixons Carphone PLC	3.1	▲10.8	2.8
22	SAFE	Safestore Holdings PLC	3.0	▲12.4	1.6

Remember, a filter is not a list of shares for you to go out and buy and sell. It is important to do some more research. In this instance, you should investigate the company's current trading, debt position and dividend history to see if it will offer you a safe dividend or not. Pay particular attention to companies in the filter with high rates of expected dividend growth. Check to see if this is coming from a regular annual dividend or being boosted with one-off special dividends.

You can create this filter in SharePad and ShareScope.

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