Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

24th February 2017

Market overview

TIDM	Name	Price	%chg 1w	%chg 1m	%chg 2/1/17	%chg 1y	1 y high	1 y low	Date 1 y high	Date 1 y low
UKX	FTSE 100	7271.37	▼-0.09	▲1.68	▲1.8	▲22	7337.81	5867.18	13/1/17	24/2/16
MCX	FTSE 250	18643.5	▼-0.333	▲2.91	▲3.13	▲14.9	18827.2	14967.9	15/2/17	27/6/16
SMX	FTSE SmallCap	5328.14	▼-0.426	▲1.88	▲3.6	▲23.4	5358.73	4272.07	15/2/17	27/6/16
AIM1	FTSE AIM 100	4360.03	▲0.374	▲4.84	▲7.1	▲35.1	4361.55	3188.77	22/2/17	27/6/16
GSPC	S&P 500	2359.76	▲0.534	▲4.17	▲5.4	▲22.8	2365.38	1921.27	21/2/17	23/2/16
UKTP…	UK Treasury 10 Year Par Yield	1.29	▼-0.769	▼-8.51	▲1.57	▼-12.2	1.72	0.61	26/4/16	12/8/16
BR$SP	Brent Oil Spot $	$56.645	▲1.51	▲2.27	▼-0.194	▲72.1	$56.965	$32.915	29/12/16	23/2/16
G$SP	Gold Spot $ per oz	$1247.…	▲0.724	▲2.47	▲8.44	▲1.39	$1366.48	$1128…	6/7/16	15/12/16
GBP…	GBP/USD - US $ per £	1.25428	▲0.454	▲0.217	▲2.13	▼-10.4	1.47895	1.20401	22/6/16	16/1/17
GBP…	GBP/EUR - Euros per £	1.1857	▲1.33	▲1.93	▲0.962	▼-6.68	1.3174	1.1066	25/5/16	13/10/16

A relatively uneventful week on the markets. The AIM 100 continues to set new highs whilst the pound has made some gains against the euro and the US dollar.

Top 10 FTSE All-Share winners

No.	TIDM	Name	%chg 1w
1	ESNT	Essentra PLC	▲21
2	MGNS	Morgan Sindall PLC	▲15.9
3	ULVR	Unilever PLC	▲12.6
4	FLYB	Flybe Group PLC	▲11.6
5	RR.	Rolls-Royce Group PLC	▲10.2
6	FDSA	Fidessa Group PLC	▲9.2
7	OTB	On The Beach Group PLC	▲8.71
8	INTU	Intu Properties PLC	▲8.33
9	CPI	Capita PLC	▲7.85
10	RWA	Robert Walters PLC	▲7.85

Top 10 FTSE All-Share losers

No.	TIDM	Name	%chg 1w
1	IRV	Interserve PLC	▼-34.9
2	NCC	NCC Group PLC	▼-34.2
3	SRP	Serco Group PLC	▼-21.4
4	VED	Vedanta Resources PLC	▼-12.8
5	PMO	Premier Oil PLC	▼-11.5
6	WG.	Wood Group (John) PLC	▼-10.9
7	WEIR	Weir Group PLC	▼-10.4
8	BVS	Bovis Homes Group PLC	▼-9.52
9	MDC	Mediclinic International PLC	▼-9.31
10	LMI	Lonmin PLC	▼-8.43

Share Discussion: Barratt Developments (LSE:BDEV)

Half year results from housebuilder Barratt Developments seemed to go down well with investors. Although turnover decreased by 5.8% (I'll have more to say on this shortly), trading profits increased by 7.4% as operating margins improved from 16.1% to 17.8%.

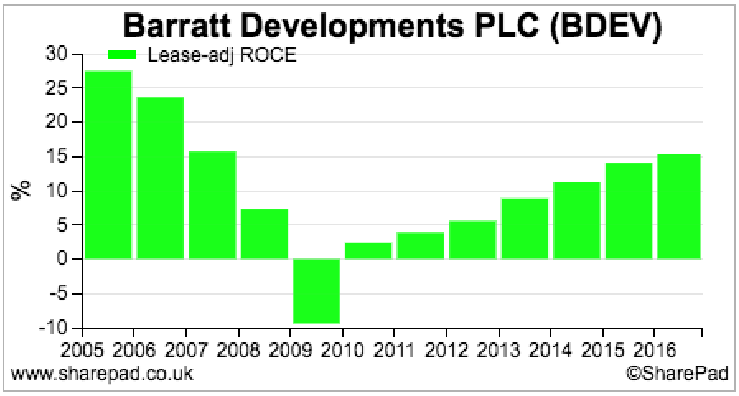
The company said it was confident about its future prospects and cited a record forward order book of over £3bn as a reason for this. Shareholders will also see a higher dividend payment going forward as the company is reducing its target underlying dividend cover from 3.0 times to 2.5 times - which means it will be paying out 40% of its profits instead of a third.

Special dividends will be paid in 2017 and 2018 as well. Investors should expect to pocket 39.3p of dividends per share in 2017 and 40p in 2018. At 523p, this gives the share a very attractive dividend yield of 7.5%. Based on the new payout ratio of 40%, an underlying dividend per share of around 22p is expected for the year to June 2017 which gives a prospective underlying yield of 4.2%.

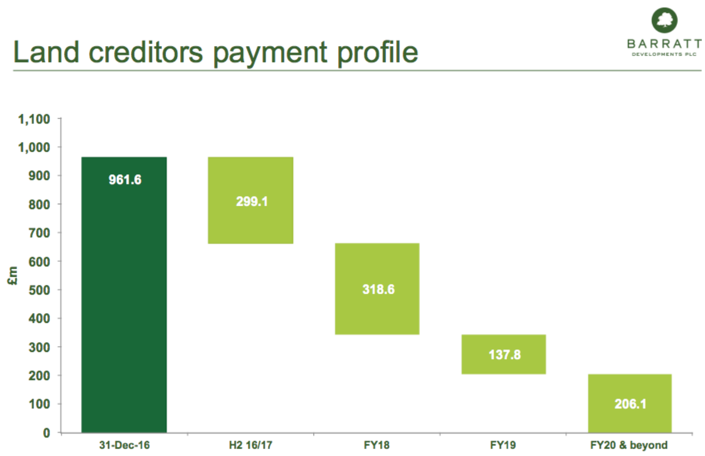
Barratt is clearly doing very well as evidenced by is return on capital employed (ROCE) improving from 25.5% a year ago to 27% now. I'd point out that Barratt's definition of capital employed differs from mine and what SharePad uses to calculate ROCE. Barratt uses average net assets (equity) and net borrowings (net cash in the case of Barratt which reduces its capital employed).

It ignores £1bn of land creditors that are treated as long-term liabilities. These reduce net assets but are debt in all but name. Consequently, SharePad calculates ROCE on a much more conservative - and arguably more realistic - basis.

The trend in ROCE is upwards but Barratt is nowhere near as profitable on this basis as it was during the last housing boom over a decade ago.



I would also argue that the company is not debt free due to the presence of land creditors. These exist because the company has bought land and has not paid for it yet. These are substantial liabilities and are running at around 35% of the value of Barratt's land bank or just under £1bn.



The cash will be paid for the land over the next few years as shown in the chart on the right.

Like most housebuilders, Barratt is doing well due to the continued rise in house prices and the smart buying of land. Its profitability is essentially a function of four variables:

- Selling prices
- The volume of properties sold
- Building costs
- Land costs

Let's look at each of these in turn.

Builders benefit when house prices increase. This is because they are building on land bought a few years previously when prices were lower (house prices are the key determinant of the price of land). House prices in the UK have been rising for the last five years whilst builders have also been able to achieve higher selling prices by changing the mix of houses sold (e.g. more houses and fewer flats).

Barratt saw the average selling price (ASP) tick up by 5.4% during the first half of its financial year but the rate of house price inflation is slowing.

Private ASP (£'000)	H1 16/17	H1 15/16	Change
Regional	286.0	266.4	7.4%
London	725.2	451.7	60.5%
Group	296.4	281.1	5.4%
JV	621.7	410.3	51.5%

The big story of the results was that Barratt sold fewer houses than a year ago. Private housing completions were down by 7.2%. This was largely down to the timing of completions in London but completions outside of London only increased by 0.4%.

Revenue Summary(1)

BARRATT DEVELOPMENTS PLC

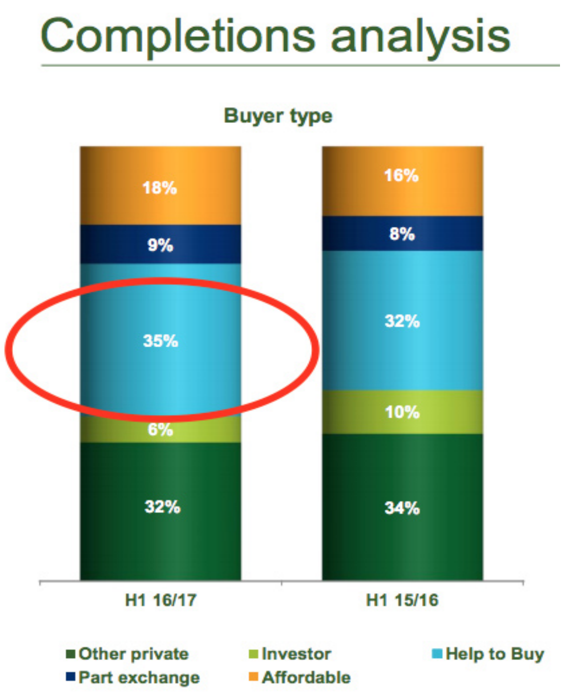
	H1 16/17	H1 15/16	Change
Completions			
Private	5,561	5,993	(7.2%)
Affordable	1,221	1,114	9.6%
Total	6,782	7,107	(4.6%)
% Affordable	18%	16%	2ppts
JV	398	519	(23.3%)
Total completions (inc JV)	7,180	7,626	(5.8%)
ASP (£'000)			
Private	296.4	281.1	5.4%
Affordable	115.3	109.2	5.6%
Total	263.8	254.2	3.8%
JV	528.8	360.6	46.6%

The company is guiding to a modest increase in completions for the year as a whole. I think this is a sign that the housing market is cooling as high prices make it more difficult for people to afford to buy despite low interest rates and the Help to Buy scheme.

I am bearish on the new build housing market in general due to the amount of assistance it is getting from the Help to Buy scheme. In my opinion, this has pushed up selling prices by creating demand that otherwise would not have been there whilst the supply of houses has not grown that quickly. This has been brilliant for builders and their shareholders but it is a false market which cannot continue indefinitely.

My view is that housebuilders such as Barratt have become too dependent on Help to Buy. During the first six months of 2016/17 it accounted for 35% of Barratt's completions compared with 32% a year earlier.

Help to Buy is scheduled to end in 2021, but what happens to that 35% of sales - and the prices they sell for - when taxpayer support is removed?



The other potentially bearish sign is that Barratt is selling blocks of flats to investors in order to keep selling volumes high. This might lead to reduced selling prices and is a further sign of a market that is not as favourable as it was a year ago.

As long as house prices do not fall and volumes do not collapse, Barratt's profits look reasonably protected for now. The main reason for this is that it is buying land at prices that will give it site profit margins of 20% and ROCE of 25%. Like many other builders, it is also buying strategic land which is cheaper as it does not have planning consent. This allows higher profit margins when consent is given and houses are sold.

The one threat to profit margins is build cost inflation. Barratt is working hard to contain this but there remains a shortage of skilled labour. Build cost inflation is expected to be 2-3% for 2017 and 3-4% for 2018. If selling prices do not increase at the same rate or fall slightly then profit margins could be at risk of falling.

As things stand, I think we will see upgrades to profit forecasts from City analysts for 2017. According to my calculations, the trailing twelve month (TTM) EPS is 56.9p compared with a consensus EPS estimate for 2017 of 55p. EBIT margins should be higher than currently predicted. Consensus dividend forecasts are also too low.

Barratt Developments PLC (BDEV)

← Prev Next →	2014	2015	2016	2017	2018	2019
Fiscal period ending	30/6/14	30/6/15	30/6/16	1/6/17	1/6/18	1/6/19
£ millions unless stated	Q4	Q4	Q4	Forecast	Forecast	Forecast
KEY FORECASTS						
Turnover	3,157.0	3,759.5	4,235.2	4,412.4	4,549.0	4,490.6
%chg	▲21.1	▲19.1	▲12.7	▲4.2	▲3.1	▼-1.3
EBITDA	452.5	625.2	748.4	716.6	739.6	739.1
EBIT	450.5	621.9	743.9	713.6	738.3	742.8
EBIT margin	14.3	16.5	17.6	16.2	16.2	16.5
EPS(p)	30.6	44.6	54.5	55.0	58.6	58.8
EPS % chg	▲109.5	▲45.8	▲22.0	▲1.0	▲6.5	▲0.3
DPS(p)	10.3	15.1	18.3	36.1	38.1	41.4
DPS % chg	▲312.0	▲46.6	▲21.2	▲97.3	▲5.5	▲8.7
Dividend cover	3.0	3.0	3.0	1.5	1.5	1.4

The outlook for 2018 is less certain as a lot depends on how the UK housing market develops.

Barratt looks like an attractive share for income seekers at the moment. The prospect of capital growth is less certain. The shares are 8.6% lower than a year ago and with little growth in profits expected, combined with concerns about the housing market, it might be hard for the shares to make much progress.

Tangible NAV per share is currently 310p. At 523p, the shares are trading on a P/NTAV of 1.7x. That looks more than reasonable to me given the TTM return on tangible equity of 18% and the historic boom bust nature of the housebuilding sector.

Share Discussion: Hotel Chocolat (AIM:HOTC)

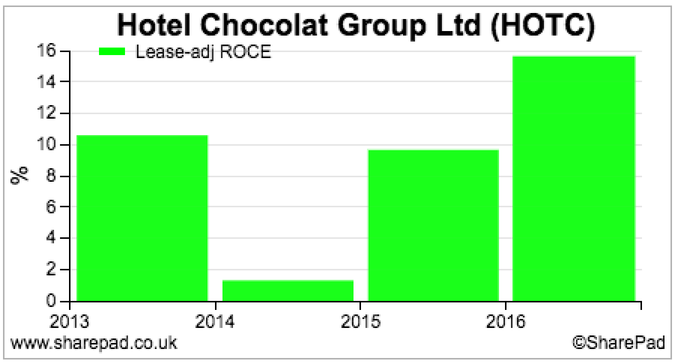
Hotel Chocolat has only been listed on the AIM market since May last year but it has proven to be a popular share with investors. I see this company as being very similar to Patisserie Holdings (LSE: CAKE) in that it is a play on premium products sold as affordable treats.

Hotel Chocolat makes virtually all its money from the UK. It has 93 shops, 10 shops with a cafe inside, and it sells chocolates over the internet - where sales were up 23% during the first half of the year. There is also a cocoa plantation and a hotel in St Lucia.

Trading is currently good according to this week's half year results statement. Sales were up 12% but trading profits (EBIT) were up by 26.2% showing that there is some significant operating leverage with this company – i.e. the change in profits is more than the change in sales due to the presence of fixed costs.

Although the company did not disclose an underlying or like-for-like sales figure it did say that the 10 new stores it opened contributed 4% to sales growth. This implies that underlying sales grew by a healthy 8%.

The company looks as if it may have the hallmarks of an excellent business. Profit margins are high and have increased from 16.8% to 18.7% during the first half of the year. However, this is very misleading as I will explain shortly.



ROCE has been trending up and is now at a high level. The question is: can it be sustained?

It all depends on how many shops it can open up and how long it takes to do so. The company is quite vague about the potential number of stores in its results release and analyst presentation.

It does have a differentiated product by focusing on selling chocolates with a high proportion of cocoa over sugar. It also has a major competitive advantage in that it makes its own chocolates in-house (known as vertical integration) which allows it much better control of its costs and product quality.

The company is also very interesting from a financial analysis point of view. When you are looking at the half year results of a company - particularly retailers - you can get a good insight of how seasonal its profits might be. You can also work out its trailing twelve month (TTM) profitability (take last year's first half profits away from FY to get H2 and then add that number to this year's first half profit figure) and see how the company is progressing and whether analysts' forecasts are achievable or not.

Doing this kind of analysis with Hotel Chocolat is very revealing.

If you look at the table below it shows that Hotel Chocolat makes all its profit in the first half of its financial year - between the months of June and December. It actually loses money between January and June.

Despite having chocolate-buying occasions such as Valentines' Day, Easter and Mothers' Day in its second half, it doesn't make any money. This is telling you that it is very dependent on Christmas trading for its annual profits. This is a risk that any investor needs to be aware of.

The first half profit margin of 18.7% is therefore not representative of what the company can achieve for a full year. If it was, I would say that Hotel Chocolat was a very high quality business. What we can see is that operating margins on a TTM basis have improved from 7% in June 2016 to 8.9% in December. This is good progress.

Hotel Chocolat £m	H1 16	H2 16	FY 16	H1 17	TTM
Revenue	54.9	**36.2**	91.1	62.5	98.7
Cost of sales	-17.9	**-12.3**	-30.2	-20.0	-32.3
Gross profit	37.0	**23.9**	60.9	42.5	66.4
Admin expenses	-27.8	**-26.7**	-54.5	-30.9	-57.6
Operating profit	**9.2**	**-2.8**	**6.4**	**11.7**	**8.8**
Net interest	-0.4	**-0.3**	-0.8	-0.4	-0.8
Profit before tax	8.8	**-3.2**	5.6	11.2	8.0
Taxation	-1.8	**0.3**	-1.5	-2.4	-2.1
Profit after tax	**7.0**	**-2.9**	**4.1**	**8.8**	**5.9**
Shares in issue(m)	112.8	**112.8**	112.8	112.8	112.8
EPS(p)	**6.2**	**-2.6**	**3.6**	**7.8**	**5.2**
Ratios:					
Gross margin	67.4%	**65.9%**	66.8%	68.0%	67.3%
Operating margin	16.8%	**-7.9%**	7.0%	18.7%	8.9%
Net profit margin	12.7%	**-8.0%**	4.5%	14.1%	6.0%

We can also see that TTM profit before tax is £5.9m and EPS is 5.2p. Consensus EPS forecast for the year to June 2017 is 7.5p. This implies a loss per share of 0.3p in the second half of the year (7.8p – 0.3p = 7.5p) and a significant improvement on last year's second half performance (-2.6p).

It might deliver, but given that the company is sounding cautious on things like cost pressures my view is that analysts are expecting quite a lot. There is scope for disappointment here in my opinion.

As with profits, Hotel Chocolat's cash flow is also very seasonal. The first half not only sees higher profit but a big cash inflow from increases in payables (mainly bills and taxes that have not been paid). This inflow from payables is largely reversed during the second half of 2016 as the cash was needed to pay the bills.

This means that during the second half of last year there was a substantial amount of cash flowing out of the company.

However, we can see on a TTM basis that Hotel Chocolat has significantly improved its operating and free cash flow which is a positive development.

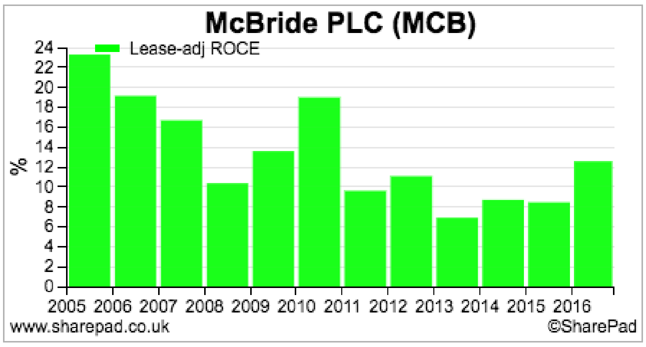
Hotel Chocolat £m	H1 16	H2 16	FY 16	H1 17	TTM
Operating cash flow before working capital	10.8	-1.0	9.8	13.7	12.7
Change in stocks	-1.6	-0.7	-2.3	-0.7	-1.3
Change in debtors	-1.4	1.0	-0.3	-1.0	0.0
Change in creditors	8.9	-7.3	1.5	10.8	3.5
Cash generated by operations	**16.7**	**-8.0**	**8.7**	**22.8**	**14.8**
Net interest	-0.5	-0.1	-0.7	-0.1	-0.3
Tax paid	0.0	-0.6	-0.5	-0.6	-1.2
Capex	-3.1	-3.3	-6.4	-4.8	-8.1
Free cash flow	**13.0**	**-12.0**	**1.0**	**17.3**	**5.3**

I think Hotel Chocolat is a decent business albeit one with a high degree of seasonal risk. The valuation of the shares is very high. At a share price of 265p, the shares trade on a TTM PE of 51 times and a 2017 forward PE of 35.3 times. It looks as though a lot of future profits growth has been priced into the shares.

Share Discussion: McBride (LSE:MCB)

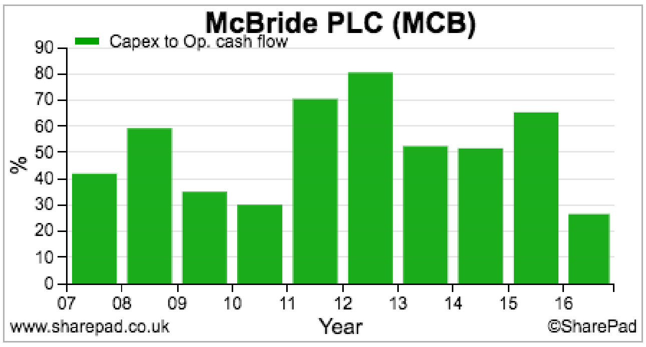
Last week's bid by Kraft-Heinz for Unilever has highlighted the attractions of branded consumer goods companies. The strength of branded products allows the companies that make them to exercise a degree of pricing power with powerful supermarkets because their customers want to buy them.

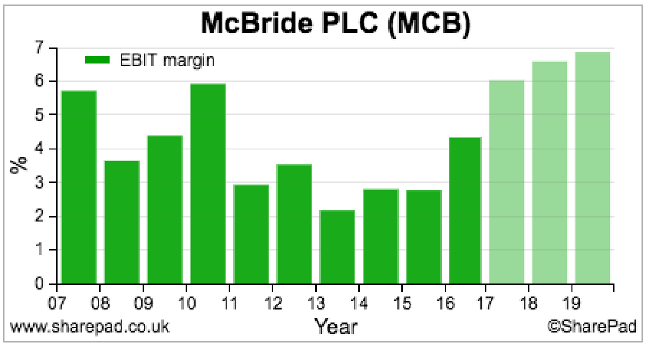
McBride specialises in making own-label household and personal care consumer products and generally has a much tougher time passing on price increases. This has not stopped its shares performing well over the last couple of years following some troubled times for the company.



The troubled times are seen in the dramatic fall in profitability over the last decade. ROCE has started to improve as the company targets an improvement in operating margins to 7.5% by 2020.

McBride operates in very tough markets. Its business has historically been very capital intensive but the company has cut back on spending recently as it tries to improve profitability. Capex is expected to rise again and will total £100m over the next four years as the company attempts to grow again.





Making personal and homecare products involves buying lots of raw materials (e.g. chemicals and plastics) where the costs move around a lot. McBride's customers have immense buying power which makes it difficult to pass on cost increases. When costs fall they are under pressure to pass them on in lower prices.

This makes it difficult for McBride to earn decent profit margins as shown in the chart above-right.

Yet analysts are expecting the company's strategy of cost cutting and simplification of its product range to bear fruit with rising profit margins (the lighter bars in the chart) over the next three years.

If you compare McBride's profit margins with those earned by the big global branded personal and household care companies then you quickly understand the relative weakness of its competitive position.

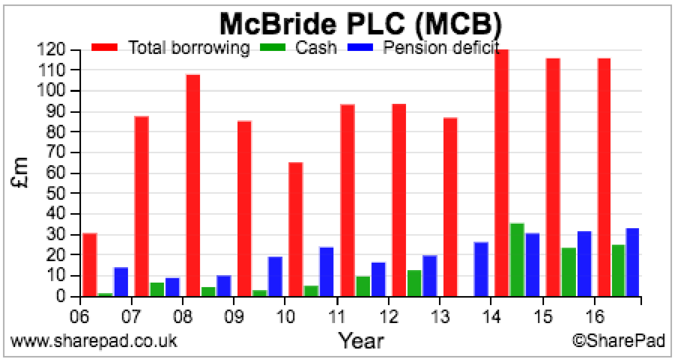
TIDM	Name	EBIT margin
CL	Colgate-Palmolive Co	18.1
EPC	Edgewell Personal Care Co	12.3
RB.	Reckitt Benckiser Group PLC	24.4
ULVR	Unilever PLC	15.2

High profit margins protect a business from a sudden rise in costs. They are also often a sign of competitive strength. McBride comes up short here.

However, the company is trying hard to make improvements. Half year profits saw underlying sales fall by 7% but its cost cutting plans are making good progress and trading profits grew by 30.1% and EPS by 44.9%.

The company also mentioned that it had been approached by third parties interested in buying its Aerosols business which might make its strategy easier to achieve. It would also help McBride to pay off some of its debts which look too high for a business with a weak competitive position.

This is a business that does not want a lot of financial gearing and I see its current debt to enterprise value (including its pension deficit) of 34% as being higher than it ideally should be.



The company is on track to meet full year profit expectations but there is a risk that it might not be able to recover cost increases from its customers.

> *"For the second half year, current expectations are for constant currency underlying revenues to be slightly lower year-on-year, in line with the performance witnessed in the first half year. As planned the impact from the "customer choices" project will reduce second half revenues by approximately GBP6.0 million. A number of business wins however, secured in the past six months, will start to be evident in our top line as we start the new financial year in July 2017.*
>
> ***Uncertainty in both the size and timing of raw material inflation and changes to foreign exchange rates is to be expected in the second half of the year. We will work closely with customers to mitigate these but it is likely the second half will see some lag effect between higher input prices and margin recovery.***
>
> *While trading conditions in the second half are expected to remain challenging, we believe our ongoing margin and cost initiatives position us well to mitigate these effects. As such, the Board's full year expectations remain unchanged."*

McBride PLC (MCB)

← Prev Next →	2014	2015	2016	2017	2018	2019
Fiscal period ending	30/6/14	30/6/15	30/6/16	1/6/17	1/6/18	1/6/19
£ millions unless stated	Q4	Q4	Q4	Forecast	Forecast	Forecast
KEY FORECASTS						
Turnover	744.2	704.2	680.9	710.4	708.8	736.8
%chg	▼-2.3	▼-5.4	▼-3.3	▲4.3	▼-0.2	▲3.9
EBITDA	45.7	40.1	48.6	60.0	65.3	70.3
EBIT	20.8	19.5	29.5	42.8	46.7	50.6
EBIT margin	2.8	2.8	4.3	6.0	6.6	6.9
EPS(p)	8.4	5.1	7.3	13.0	15.0	16.8
EPS % chg	▲130.6	▼-39.8	▲44.1	▲77.6	▲15.4	▲12.0

At 170p, McBride shares trade on a June 2017 PE of 13.1 times with forecast EPS growth to June 2018 of 15.4%. Although this is coming from cost cutting rather than turnover growth it does put the shares on a PEG ratio of 0.85 which might mean the shares could still offer some upside potential over the coming months.

Filter of the week - companies with low capex requirements

One of the most attractive characteristics of a quality company is not requiring a lot of money to grow. You can identify such companies by looking at the **Capex ratio** which compares the cash spent on new assets (capex) with the amount of cash flow a company generates from trading (cash flow from operations).

I see a capex ratio which is consistently less than 30% as being low. Low capex ratios can help a company earn high returns on capital (ROCE) as well as generating lots of free cash flow - two characteristics that can help you identify profitable long-term investments.

Below is a list of FTSE All-Share companies with capex ratios of less than 15% and their most recent ROCE.

Capex ratio vs ROCE

Add criteria | Exit

- ☑ Capex to Op. cash flow — Min: (blank) Max: 15
- ☑ Lease-adjusted ROCE (7x, 7%) — Min: 20 Max: (blank)

No.	TIDM	Name	Capex to Op. cash flow	Lease-adj ROCE (7x, 7%)
1	ASHM	Ashmore Group PLC	0.5	21.8
2	LIO	Liontrust Asset Manage...	1.0	34.7
3	RMV	Rightmove PLC	1.2	929.9
4	BWY	Bellway PLC	1.4	25.5
5	AUTO	Auto Trader Group PLC	1.7	45.0
6	PSN	Persimmon PLC	1.8	22.9
7	CLIG	City of London Investme...	1.8	47.1
8	HL.	Hargreaves Lansdown P...	3.2	83.4
9	SCT	Softcat PLC	4.6	48.5
10	DPLM	Diploma PLC	4.8	23.2
11	JUP	Jupiter Fund Manageme...	4.9	26.3
12	CMCX	CMC Markets PLC	5.0	27.3
13	BKG	Berkeley Group Holding...	5.2	28.1
14	GOCO	Gocompare.com Group ...	5.3	77.3
15	SNN	Sanne Group PLC	6.0	33.9
16	IGG	IG Group Holdings PLC	6.1	31.6
17	INDV	Indivior PLC	6.8	43.9
18	FDM	FDM Group Holdings PLC	7.2	49.6
19	MOTR	Motorpoint Group PLC	7.3	39.0
20	SGE	Sage Group (The) PLC	7.8	23.7
21	ITV	ITV PLC	8.0	40.2
22	KNOS	Kainos Group Ltd	8.3	49.6
23	DOM	Domino's Pizza UK & IR...	8.4	32.7
24	HAS	Hays PLC	10.4	24.2
25	BATS	British American Tobacc...	11.1	24.5
26	PAY	PayPoint PLC	11.9	49.6
27	OTB	On The Beach Group PLC	14.5	20.1
28	PAGE	PageGroup PLC	14.9	24.2

Capex ratio vs ROCE

Add criteria | Exit

- ☑ Capex to Op. cash flow — Min: (blank) Max: 15
- ☑ Lease-adjusted ROCE (7x, 7%) — Min: 20 Max: (blank)

No.	TIDM	Name	Capex to Op. cash flow	Lease-adj ROCE (7x, 7%)
1	NUM	Numis Corporation PLC	0.6	22.6
2	POLR	Polar Capital Holdings P...	1.1	26.1
3	PLUS	Plus500 Ltd	1.3	128.8
4	FEVR	Fevertree Drinks PLC	2.8	25.2
5	RWS	RWS Holdings PLC	3.0	23.2
6	QTX	Quartix Holdings PLC	3.9	39.0
7	NICL	Nichols PLC	7.8	38.0
8	SFE	SafeStyle UK Ltd	8.7	31.5
9	RNWH	Renew Holdings PLC	9.1	26.1
10	JHD	James Halstead PLC	9.6	32.4
11	CRW	Craneware PLC	14.7	27.0

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