Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

10th March 2017

Market overview

Stock markets - with the exception of AIM - have stopped going up. I am not surprised. In fact, I am starting to worry about the level of share prices given a backdrop of rising inflation (not helped by the continued fall in the value of the pound) and lower growth.

This week, we have seen two very high quality businesses in the form of Dignity (see later) and Domino's Pizza suffer big share price declines as they told investors that growth has slowed. Both shares were trading on very expensive valuations in anticipation of strong future profits growth which left their shareholders very exposed to bad news.

There are many high quality companies out there with high valuations and low growth rates. At lower valuations, they would make good long-term investments but with PE ratios of 20 or more they look increasingly high-risk if growth disappoints.

The other big move this week has been the slump in the oil price. Just over a year ago, a sharply falling oil price also coincided with falling stock markets. Could the same scenario play out again? It depends on what is driving the price lower. If it is due to oversupply of oil then the falling oil price will boost consumer spending power. If it is due to weakening economic growth that would be more cause for concern.

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7314.96	▼-0.913	▲1.18	▲19	7382.9	5923.53	1/3/17	14/6/16
FTSE 250	18891.5	▼-0.313	▲1.42	▲13.9	18983	14967.9	1/3/17	27/6/16
FTSE SmallCap	5348.3	▼-0.134	▲0.937	▲19.2	5371.66	4272.07	8/3/17	27/6/16
FTSE AIM 100	4422.83	▲0.359	▲2.55	▲35.3	4432.02	3188.77	8/3/17	27/6/16
S&P 500	2364.94	▼-0.713	▲2.47	▲18.9	2395.96	1989.26	1/3/17	9/3/16
UK Treasury 10 Year Par Yield	1.15	▼-1.71	▼-10.2	▼-24.3	1.72	0.61	26/4/16	12/8/16
Brent Oil Spot $	$51.605	▼-6.25	▼-7.39	▲26.3	$56.965	$37.59	29/12/16	4/4/16
Gold Spot $ per oz	$1204.30	▼-2.52	▼-1.82	▼-3.94	$1366.48	$1128.22	6/7/16	15/12/16
GBP/USD - US $ per £	1.2166	▼-0.869	▼-2.64	▼-14.4	1.47895	1.20401	22/6/16	16/1/17
GBP/EUR - Euros per £	1.1491	▼-1.63	▼-2	▼-11.1	1.3174	1.1066	25/5/16	13/10/16

Top 10 FTSE All-Share winners

No.	TIDM	Name	%chg 1w
1	RTN	Restaurant Group (The) PLC	▲17.6
2	SHAW	Shawbrook Group PLC	▲15.8
3	JE.	Just Eat PLC	▲14.7
4	TYMN	Tyman PLC	▲11.8
5	CMCX	CMC Markets PLC	▲11.5
6	ULE	Ultra Electronics Holdings PLC	▲11.2
7	HILS	Hill & Smith Holdings PLC	▲9.8
8	LSL	LSL Property Services PLC	▲8.79
9	MCLS	McColl's Retail Group Ltd	▲8.74
10	TNI	Trinity Mirror PLC	▲8.66

Top 10 FTSE All-Share losers

No.	TIDM	Name	%chg 1w
1	LMI	Lonmin PLC	▼-28.2
2	BRSN	Berendsen PLC	▼-16.2
3	ACA	Acacia Mining PLC	▼-16.2
4	AGK	Aggreko PLC	▼-15.6
5	ENQ	EnQuest PLC	▼-14.6
6	KAZ	KAZ Minerals PLC	▼-13.9
7	GOG	Go-Ahead Group (The) PLC	▼-13.1
8	FXPO	Ferrexpo PLC	▼-12.3
9	DOM	Domino's Pizza UK & IRL PLC	▼-12.3
10	VED	Vedanta Resources PLC	▼-11.9

Share Discussion: Direct Line (LSE:DLG) - can dividends grow?

Insurance companies can be very difficult companies for the private investor to understand. There are so many moving parts and so much information that it can be quite daunting to scrutinise their financial performance.

General insurance companies (such as motor and home insurance) are easier to understand than life and reinsurance companies in my opinion. In most cases though, the profitability of insurance companies boils down to two things:

1. The **underwriting profit** - This is the revenue from selling insurance policies less the cost of claims, commissions and the expenses of running the business.
2. **Investment returns** - Insurers invest the premiums received from customers in bonds, shares and property. These generate income and are subject to capital gains or losses.

Insurers make more money in three ways:

1. Selling more policies at the same or higher prices.
2. Controlling costs
3. Generating higher investment returns.

Direct Line's 2016 results look to be quite reasonable. Its gross written insurance premiums increased by 3.9% as the company's core motor and home insurance businesses sold more insurance than in 2015. Underlying operating profits increased by 12.4% from £507.5m to £570.3m.

However, the results are a little bit more complicated due to a one-off adjustment made to the value of potential future claims.

Let's look at Direct Line's underwriting performance a little more closely. In the table below, you can see how it is made up of three main ratios. These are:

1. The **Claims ratio** (also called Loss ratio) - This is the amount paid out in insurance claims as a percentage of *Net earned premium income* (NEP). NEP is the gross earned insurance premium for the year less the amount paid to reinsurance companies to cover some of the insurance on policies.

2. The **Commission ratio** - The amount of money paid in commissions to agents as a percentage of NEP.

3. The **Expense ratio** - The costs of running the business (wages & overheads etc.) as a percentage of NEP.

Direct Line	Motor		Home		Rescue & Other		Commercial	
%	2016	2015	2016	2015	2016	2015	2016	2015
Claims ratio	74.9	63.6	40.7	51.5	61.6	59.9	55.3	62.7
Commission ratio	3.2	2.6	22.6	20.9	7.2	6.4	19.5	19.6
Expense ratio	28.2	26.2	21.7	19.8	24.5	24.9	23.9	22.2
Combined operating ratio	106.3	92.4	85	92.2	93.3	91.2	98.7	104.5

Adding these three ratios together gives an insurance company's **Combined operating ratio** (COR). For there to be an underwriting profit, the COR has to be less than 100%.

As you can see, the Motor Insurance business made an underwriting loss for 2016 with a COR of 106.3%. However, this was entirely due to a one-off effect of adjusting claims reserves (claims that have not been paid yet but are expected to be in the future) for a new ruling on accounting for bodily injury claims such as whiplash. This led to a one-off increase in costs of £175m and pushed up the COR by 11.2%. The underlying COR for the motor division was 95.1%.

Home insurance made more money in 2016 due to lower weather-related claims as did the Commercial business. The Rescue business was slightly less profitable.

The *overall* underlying insurance COR was 91.8%. Put another way, Direct Line kept £8.20 in profit (£100 less £91.80) for every £100 of insurance policies sold. This was better than normal and it is targeting a COR of 93-95% in 2017 assuming a return to more normal weather conditions.

The fact that Direct Line is making an underwriting profit is a good sign. It is not always easy to do this. The company is very selective in who and what it will insure and tends to adopt a lower risk profile amongst its customers to keep claims lower.

If you look at the table on the right, you can see that Direct Line makes considerable profits from instalment income (effectively the interest policyholders have to pay for monthly rather than annual premiums). It also makes money from accident repair and car hire referrals (not in the table). Profits from these sources were up by just under £15m in 2016.

Operating profit - Ongoing operations

	H2 2016 GBPm	H2 2015 GBPm	FY 2016 GBPm	FY 2015 GBPm
Underwriting profit / (loss)	(84.1)	22.0	70.1	175.2
Instalment and other operating income	86.9	78.0	165.3	150.8
Investment return	77.1	84.9	168.1	194.7
Operating profit	79.9	184.9	403.5	520.7

I am not entirely convinced about the quality and sustainability of profits from these sources. Insurers have been criticised for the prices of monthly premiums whilst car hire and accident repairs referrals could be seen to have conflict of interest issues. The profits that Direct Line makes from these sources make up a sizeable chunk of its total operating profits and could represent a source of future risk for investors.

It is getting harder and harder for insurers to generate decent investment returns from their invested insurance premiums (known in the trade as 'float'). Companies have taken a low risk to investing and have shied away from shares because they don't want to put their solvency at risk. This might happen if there was a stock market crash and the value of the investment portfolio was insufficient to meet future insurance claims.

Unsurprisingly, Direct Line has an investment portfolio with lots of bonds.

Direct Line investment portfolio

Bonds currently offer low rates of income. The risk facing insurers is that old bonds with higher rates of interest have to be replaced with new ones which offer lower rates. This would lead to lower investment income. I think it will be hard for Direct Line to grow its investment income in the short-term.

As at	31 Dec 2016 GBPm	30 Jun 2016 GBPm	31 Dec 2015 GBPm
Investment-grade credit(1)	3,888.3	3,704.8	4,060.0
High yield	409.9	358.9	327.4
Investment-grade private placements	85.1	60.0	13.5
Credit	4,383.3	4,123.7	4,400.9
Securitised credit(1,2)	–	317.5	350.8
Sovereign	341.2	456.6	442.7
Total debt securities	4,724.5	4,897.8	5,194.4
Infrastructure debt	337.0	342.7	329.6
Commercial real estate loans	79.7	17.7	–
Cash and cash equivalents(3)	1,110.8	989.7	947.3
Investment property	329.0	348.6	347.4
Total Group	6,581.0	6,596.5	6,818.7

Rising interest rates would help this, but it would also reduce the capital value of outstanding bonds (bond prices move in the opposite direction to changes in interest rates) and weaken an insurer's financial position.

Direct Line's finances are in good shape at the moment. It has low gearing and comfortably more capital than it needs to meet industry solvency standards.

Despite having a strong brand, the company operates in fiercely competitive markets where price is the main determinant. This could make it hard for Direct Line to deliver meaningful growth in profits and dividends in the future.

The company likes to pay out most of its profits in dividends to shareholders and has paid a number of special dividends in recent years. Total dividends paid in 2016 were 24.6p versus 50.1p in 2015. Current consensus analysts' forecasts for 2017 are for a dividend per share of 26.8p. At a share price of 336p this gives the shares a prospective dividend yield of 8%.

That is clearly attractive in these days of low interest rates but does this mean that the shares are cheap. My rough and ready reckoner for valuing financial companies is to compare their returns on equity (ROE) with what is known as their cost of equity (the return that investors require to own the shares.) to get an implied P/NAV valuation.

Therefore implied P/NAV = ROE/Cost of equity.

History tells us that financial companies can be quite risky. I therefore assume that investors would want at least a 10% annual return to own them. Direct Line is targeting a 15% return on its tangible equity. If it can do this and it is sustainable, then the implied P/NTAV should be 1.5 times (15%/10%)

Direct Line's adjusted EPS for 2016 was 21.2p and its tangible NAV per share (NTAVps) was 147.4p. Dividing EPS by NTAVps gives a return on tangible equity of 14.4%.

Let's say that 15% is achievable and sustainable, then this would give an estimated fair value per share of 147.4 x 1.5 = 221p. This would be telling us that, at 337p, the shares are very expensive. A trailing PE of 15.8 times indicates that the shares are not particularly cheap either.

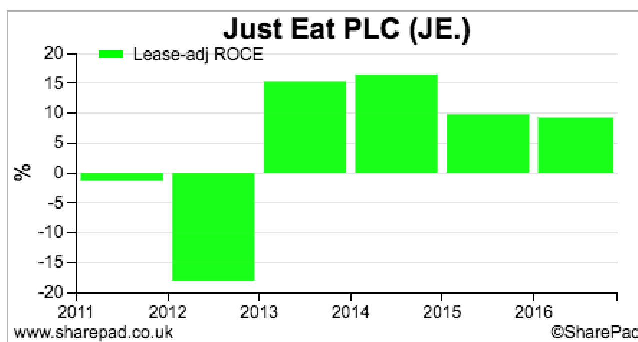
It is also telling us that it is the dividend stream and the yield which is supporting the share price. If the dividend can be maintained and interest rates stay low then the shares may retain some support from income seekers.

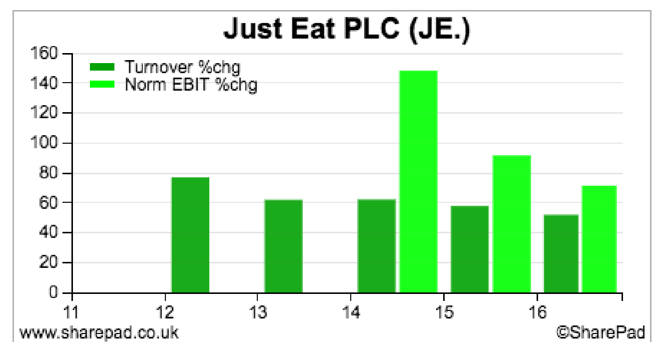
Share Discussion: Just Eat (LSE:JE.) - are the shares as expensive as they look?

Just Eat has been a very successful investment having virtually doubled in price since listing on the stock market just under three years ago. It is a technology company which links customers with 68,500 take away food restaurants and is growing rapidly. It makes money by taking a fee from restaurants from joining up and a percentage commission on all orders placed.

The company was loss-making until 2013 but then quickly improved its ROCE up to the high quality threshold of 15%. ROCE has dropped back over the last couple of years as it has spent heavily on acquisitions in overseas markets. It is currently trying to buy its main UK rival - hungryhouse - for £240m but this is subject to clearance from the competition authorities. This is likely to depress ROCE as well.

However, fast growing technology companies can have fantastic operating leverage. Because many of its costs are fixed, extra sales don't come with many extra costs and so profits can grow much faster than sales. This is what has been happening at Just Eat as shown in the chart below.

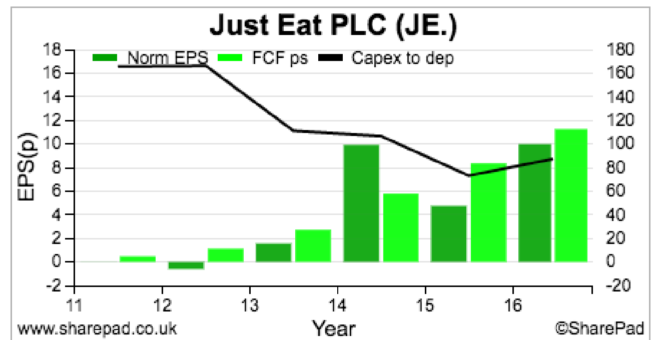




The operational leverage is feeding through to higher profit margins.

If Just Eat can make a success of its acquisitions and get profits growing quickly then it is possible that it could generate impressive improvements in profit margins and ROCE in the coming years.

Excluding acquisitions, investment requirements are low. This has seen Just Eat post impressive rates of free cash flow conversion of its profits during the last couple of years.



A closer look at the business

The core UK business is still performing really well. Orders grew by 31% and revenues by 39.8%. A full year of owning the Australian & New Zealand business has seen decent growth as well.

Established markets including France, Denmark, Ireland, Switzerland, Canada and Norway are not growing as fast as the UK. Developing markets include Italy, Spain and Mexico. The company is excited about the potential for its overseas markets as they are less developed and could offer significant growth potential.

As you can see bottom-right, the bulk of the company's profits (EBITDA) are generated in the UK. EBITDA increased by 57% in the UK last year - which is an impressive result - and more than doubled in established markets.

The task now is to turn the developing markets from losses into profits and start achieving the benefits of operating leverage that has been seen in the UK.

The bullish case for Just Eat is that it keeps on growing rapidly to become the Rightmove of the take away food market in the UK and its overseas markets.

Its strategy is not without risk. Whilst it can offer easy ordering for customers and new sales leads for restaurants, the restaurants in the UK are paying 14% of their sales in commission to Just Eat.

	Year ended 31 December 2016 million	Year ended 31 December 2015 million
Segment orders		
United Kingdom	88.1	67.3
Australia & New Zealand (from 15 June 2015)	13.8	5.9
Established Markets	21.6	17.9
Developing Markets	12.9	5.1
Total orders	136.4	96.2

	Year ended 31 December 2016 GBPm	Year ended 31 December 2015 GBPm
Net revenues		
United Kingdom	237.1	169.6
Australia & New Zealand (from 15 June 2015)	36.8	12.4
Established Markets	75.5	55.8
Developing Markets	26.2	9.5
Total segment revenues	375.6	247.3
Head Office	0.1	0.3
Total revenues	375.7	247.6

	Year ended 31 December 2016 GBPm	Year ended 31 December 2015 GBPm
Underlying EBITDA		
United Kingdom	121.8	77.6
Australia & New Zealand (from 15 June 2015)	7.6	1.0
Established Markets	13.3	6.4
Developing Markets	(13.7)	(13.9)
Total segment Underlying EBITDA	129.0	71.1
Share of equity-accounted associates (excluding depreciation and amortisation)	0.5	(1.9)
Head Office	(14.2)	(9.5)
Total Underlying EBITDA	115.3	59.7

This is a big number and could attract new competition. It may also be the reason why Just Eat's desire to buy hungryhouse could be blocked by the UK competition authorities.

The outlook for 2017 however is encouraging. The company has forecast sales of between £480-495m (growth of 28-31%) and EBITDA of £175-£163m (growth of 36.1-41.4%). This outlook is reflected in a very high valuation of the shares. With 2016 EPS of 10p and a share price of 576p, they trade on a trailing PE ratio of 57.6 times.

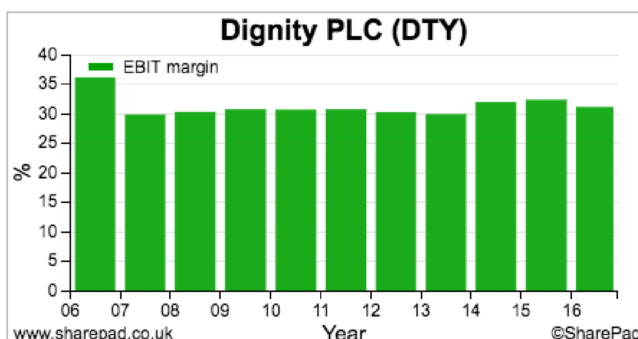
Yet EPS is expected to grow by 64% to 16.4p in 2017 and by a further 33.5% to 21.9p in 2018. This reduces the PE to 35.1 times in 2017 and 26.3 times in 2018.

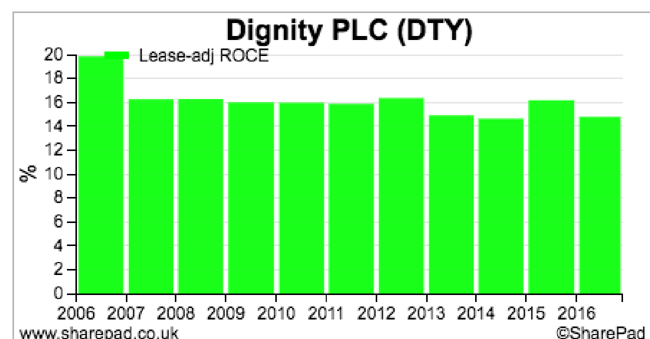
This is not cheap by any means but the price earnings growth (PEG) factor is 0.9 and the forecast PEG is 1.06. I'm not a big fan of PEG - as I see it of more use to traders than long-term investors - but these numbers may support a view that the shares are not as wildly valued as they might first appear.

Share Discussion: Dignity (LSE:DTY) - does its moat have a hole in it?

Up until Wednesday of this week I would have described funeral provider Dignity as a great example of a high quality and resilient business. I am not so sure now. Its 2016 results statement contained some unnerving messages for investors. The stock market did not like what it read and pushed the shares sharply lower.

Dignity has many of the hallmarks of a great business. It has high profit margins and a high and stable ROCE.





2016 was a quiet year and profits only increased by 3% due to a lower death rate than 2015. However, the results statement included some worrying developments in its business:

- A decline in market share from 12.3% to 11.8%.

Dignity is making profit margins of over 30%. A basic law of economics is that high returns attract competition. With such high margins, there is plenty of scope to undercut Dignity's prices.

- A decline in the long term EPS growth rate target of the business

> *"The Board remains positive about the future prospects for the Group. However, given the increased size of the Group and increasing competition in each of our markets, the Board has revised its medium-term target underlying EPS growth rate to eight per cent per annum from the current 10 per cent. As with the previous target, this objective includes the benefit of the reinvestment of cash generated by the business and the Group's ability to releverage its balance sheet either to fund acquisitions or return capital to shareholders."*

It is important to note that this EPS growth is not organic growth but includes the benefits of future acquisitions and share buybacks. Therefore, its underlying growth is likely to be lower than the 8% target.

- A move to offering a cheaper cremation-only service which could put downwards pressure on profits.

> *"….launch of Simplicity Cremations, a nationally available, online, affordable direct cremation service (where there is no traditional funeral service, simply the collection and unwitnessed cremation of the deceased and then return of the ashes). This does not replace the full service, traditional funeral that we provide, but rather provides families with a lower cost simple option. The market for this service is currently small but given our significant national networks of funeral locations and crematoria we are able to offer this service in a more comprehensive and cost effective way than other operators."*

Funerals are a big expense for families and the cost has been rising in recent years. An average combined funeral and cremation at Dignity has increased by over 30% during the last 5 years to £4215. That is a lot of money and it is no surprise that people are looking for cheaper and simpler alternatives.

An average cremation cost £1134 at Dignity in 2016. If there is a shift towards cremation only products then Dignity will not be able to make the same amount of profit as it does from funerals and cremations.

My concern with Dignity is that its prices have reached a limit which customers could be struggling to afford. High prices have produced high profit margins and possibly increased competition. The move to lower cost products may also be a sign that funerals have just become too expensive.

I don't see Dignity's profits collapsing overnight but these developments could be the first chink in the armour of what has been an excellent business. It may mean that profit margins and ROCE have peaked and could be set to decline in the future.

The shares have rallied back to 2490p at the time of writing but, with virtually no growth in profits expected this year, they look reasonably expensive on a forward PE of 19.7 times.

Filter of the week - Ben Graham's net-nets

Legendary value investor Ben Graham used to look for shares trading at less than two thirds of their Net current asset value (NCAV). NCAV is a company's current assets less all its liabilities. There is no value given to fixed assets such as land and buildings or plant and machinery.

Graham reckoned that shares that could be bought as cheaply as two thirds of their NCAV could see handsome profits if their fortunes improved. But herein lies the problem with this strategy. The shares are often trading at such low valuations because there are grave concerns about their future.

Only 42 shares on the London stock exchange currently meet this criteria and they are mainly very small companies. That said, you might just unearth an unloved pot of gold.

Price/NCAV Net Nets Add criteria Exit

Close % of Graham NCAV ps Min: 0 Max: 67 Edit

No.	TIDM	Name	Market Cap. (m)	Close % of Graham NCAV ps
2	ACHL	Asian Citrus Holdings Ltd	£67.2	48%
3	SEE	Seeing Machines Ltd	£57.6	31.9%
4	AMYT	Amryt Pharma PLC	£38.5	10.9%
5	MPL	Mercantile Ports & Logist…	£35.0	14.5%
6	BSD	BSD Crown Ltd	£27.7	30.8%
7	CAD	Cadogan Petroleum PLC	£21.1	64.4%
8	AFG	Aquatic Foods Group PLC	£16.4	29.7%
9	SGI	Stanley Gibbons Group (…	£16.3	36.1%
10	TCF	Terra Catalyst Fund	£15.1	43%
11	RPT	Regal Petroleum PLC	£14.4	63.7%
12	MIN	Minoan Group PLC	£12.6	35.9%
13	LCG	London Capital Group Ho…	£11.4	39.1%
14	ADGO	Adgorithms Ltd	£10.2	48.3%

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.