Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

24th March 2017

Market overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7340.71	▼-1.01	▲0.954	▲18.4	7429.81	5923.53	20/3/17	14/6/16
FTSE 250	19002.3	▼-0.13	▲1.92	▲12.7	19151.8	14967.9	20/3/17	27/6/16
FTSE SmallCap	5366.53	▼-0.473	▲0.721	▲18.3	5414.66	4272.07	17/3/17	27/6/16
FTSE AIM 100	4474.69	▼-0.981	▲2.63	▲34.2	4527.15	3188.77	17/3/17	27/6/16
S&P 500	2348.45	▼-1.38	▼-0.65	▲15.3	2395.96	2000.54	1/3/17	27/6/16
UK Treasury 10 Year Par Yield	1.23	▲0.82	▲3.36	▼-18.5	1.72	0.61	26/4/16	12/8/16
Brent Oil Spot $	$50.745	▼-1.91	▼-10.2	▲25.2	$56.965	$37.59	29/12/16	4/4/16
Gold Spot $ per oz	$1246.08	▲1.6	▼-0.267	▲1.96	$1366.48	$1128.22	6/7/16	15/12/16
GBP/USD - US $ per £	1.25242	▲1.41	▼-0.242	▼-11.3	1.47895	1.20401	22/6/16	16/1/17
GBP/EUR - Euros per £	1.1614	▲1.31	▼-2.09	▼-8.02	1.3174	1.1066	25/5/16	13/10/16

Stock markets are down on the week, but not by much. For me the key thing for investors to watch in the coming weeks is the rate of inflation. Numbers released this week showed that inflation is on the rise. Rising inflation is something to worry about for investors as it can reduce the buying power of the cash flows from shares and bonds.

With wage inflation low, many companies might find it difficult to pass on inflationary cost increases in their selling prices. This could reduce profits growth and see share valuations fall.

Gold could be the main beneficiary of rising inflation. It is not really surprising that the gold price has risen this week.

Share discussion: 888 Holdings (LSE:888)

I understand why some people would not want to invest in gambling companies from an ethical point of view. In addition to these legitimate concerns, the risk associated with investing in such companies is high due to changing and increasing regulation and tax laws.

Having said this, there can be no denying that some gambling companies have proven to be particularly good investments in recent years. Whilst companies such as William Hill and Ladbrokes with their large estates of high street betting shops have been struggling, the online companies such as 888 have been doing very well.

Let's take a closer look at 888's performance.

B2C - Product segmentation

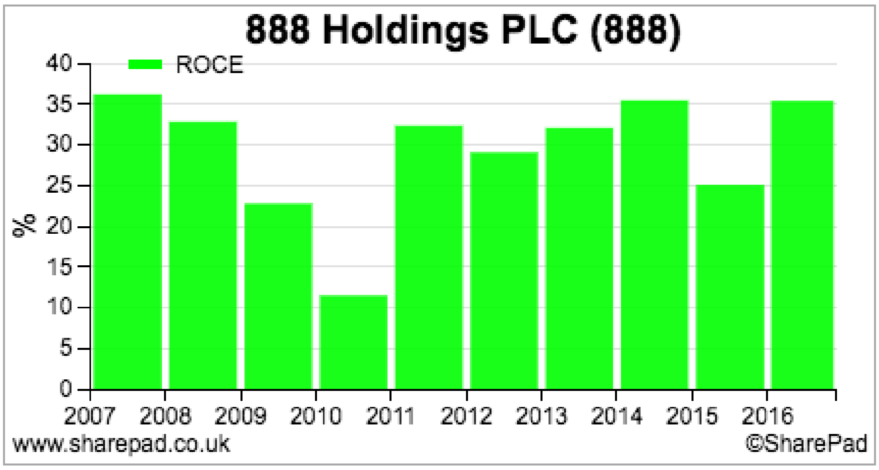
888's revenue by product segment is set out in the table below:

	2016 US$ million	2015 US$ million	Change Constant currency	Change Reported
Revenue - B2C				
Casino	**279.3**	**230.6**	26%	21%
Poker	**84.4**	**86.7**	(3%)	(3%)
Bingo	**41.8**	**44.0**	7%	(5%)
Sport[1]	**51.9**	**34.8**	58%	49%
Emerging Offerings[1]	**2.8**	**3.3**	(14%)	(15%)
Total B2C	**460.2**	**399.4**	20%	15%
B2B[1]	**60.6**	**62.7**	6%	(3%)
Revenue	**520.8**	**462.1**	18%	13%

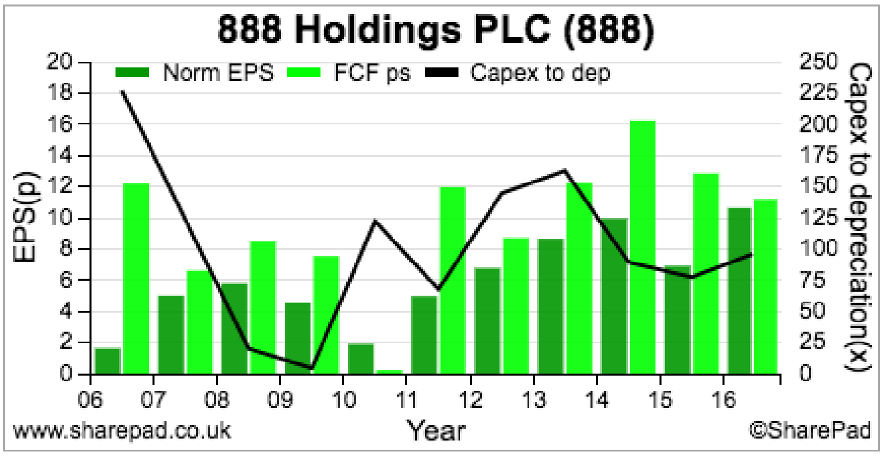
2016 was a good year for the company with a 15% growth in turnover from its consumer business. Its online casino and poker games make up the majority of its turnover in this division. Casino had a very strong year but Poker revenues fell slightly. 888 has only recently turned its attention to sports betting and saw very strong growth from this source in 2016 and will be hoping for a lot more in the years ahead.

The business to business division which sells online gaming systems and expertise to other operators saw steady growth at constant currency.

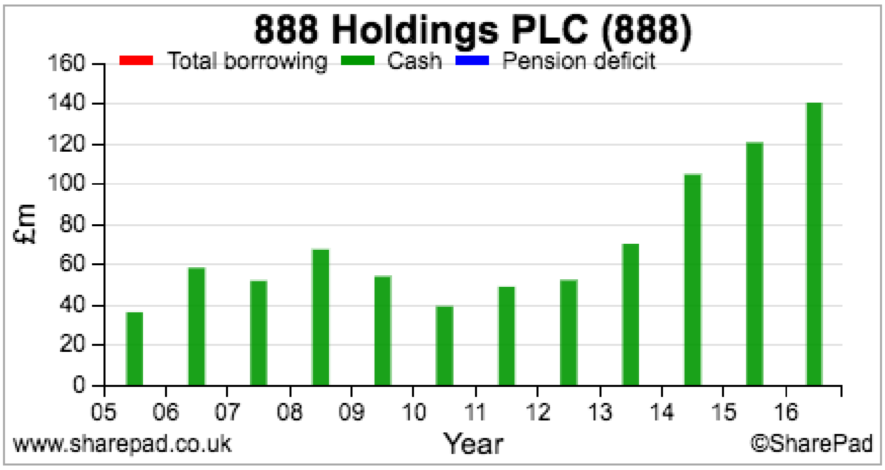
The strong growth in sales translated into a 14.5% growth in trading profits (EBIT) to $63.1m. As 888 does not have the burden of lots of money tied up in betting shops it was able to maintain its very impressive return on capital employed (ROCE)



One of the main attractions of 888 is its impressive cash flow. Free cash flow per share has been consistently more than EPS for the last six years. This is large due to it having amortised intangible assets which do not require a corresponding cash outflow to maintain them.



The high profitability and strong free cash flow has given 888 a very strong financial position. It has no debt and a rising cash balance. The strong cash flow is supporting some impressive dividend growth. The 2016 dividend has been increased by 25% and a special dividend has been paid as well.



888 has regularly paid special dividends. If its current high rates of ROCE and free cash flow performance is maintained then more special dividends could be on offer in the future.

888 is clearly performing very well. It is taking on more customers and average daily revenue in the first few weeks of 2017 is 11% higher at current exchange rates.

It is not really surprising that analysts expect 888 to continue to make steady progress going forward. That said, there are some challenges on the horizon. The future regulation of online gaming markets is always uncertain and could get tougher as social attitudes towards problems such as gambling addiction harden.

888 Holdings PLC (888)

← Prev Next →	2013	2014	2015	2016	2017	2018
Fiscal period ending	31/12/13	31/12/14	31/12/15	31/12/16	1/12/17	1/12/18
£ millions unless stated	Q4	Q4	Q4	Q4	Forecast	Forecast
KEY FORECASTS						
Turnover	257.3	276.7	300.9	423.8	442.2	482.4
Turnover %chg	▲8.5	▲7.5	▲8.8	▲40.8	▲4.3	▲9.1
EBIT	33.5	45.0	32.2	49.2	60.6	67.7
EBIT margin	13.0	16.3	10.7	11.6	13.7	14.0
EPS(p)	8.7	10.0	6.9	10.6	15.2	16.9
EPS % chg	▲27.8	▲15.1	▼-30.6	▲53.8	▲43.0	▲11.2
DPS(p)	5.8	4.9	5.0	7.0	13.3	15.4
DPS % chg	▲5.3	▼-15.4	▲0.9	▲39.7	▲90.7	▲15.8
Dividend cover	1.5	2.0	1.4	1.5	1.1	1.1

That said, regulation also acts as an effective barrier to new entrants which can compete away profits. 888 has chosen a strategy based on growing in regulated markets as it believes that it has a competitive advantage in them - from its IT, analytics and innovative marketing.

Gambling firms are also a target for governments to raise much needed taxes and this will happen in 2017 when remote gaming duties increase. The other major uncertainty is the availability of EU gambling licences after the UK leaves the EU but 888 seems reasonably relaxed on this issue.

Name	Close	fc PE	fc Yield	Lease-adj EBIT yield	P/FCF
888 Holdings PLC	253.75p	16.7	5.2	6.4	22.7

The main attraction for the shares is the chunky dividend yield with the prospects of further dividend growth. These shares may not be to everyone's taste but may tempt income seekers to look at them a bit more closely.

Share discussion: Fevertree Drinks (LSE:FEVR)

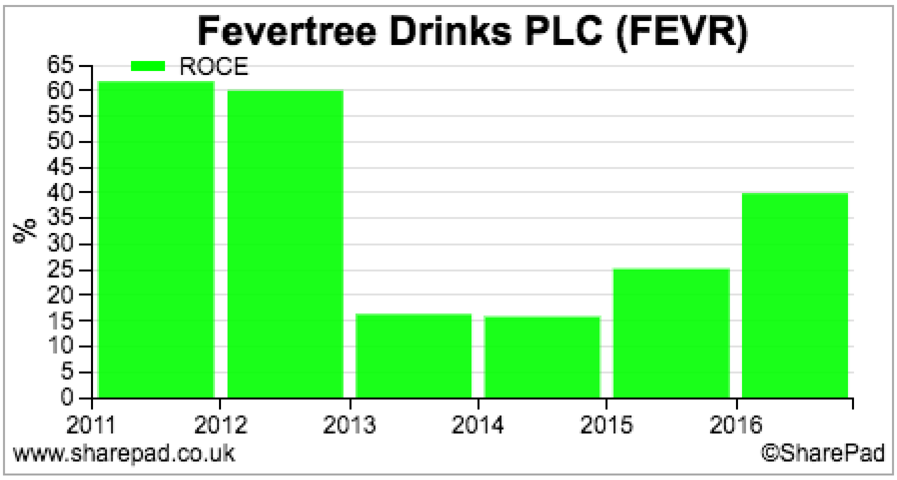
I analysed Fevertree Drinks back in May last year (click here to read my analysis). My view back then was that it was a very good business but that the valuation of its shares might be a little bit expensive.

Since then, its share price has more than doubled as its trading performance has continued to be strong and City analysts have upgraded their profit forecasts. It just goes to prove that a high quality business with rapidly growing profits can see its share price continue to rise even though its shares look expensive on traditional value methods. Fevertree is a classic example of momentum investing paying off on the back of upgraded profit forecasts.

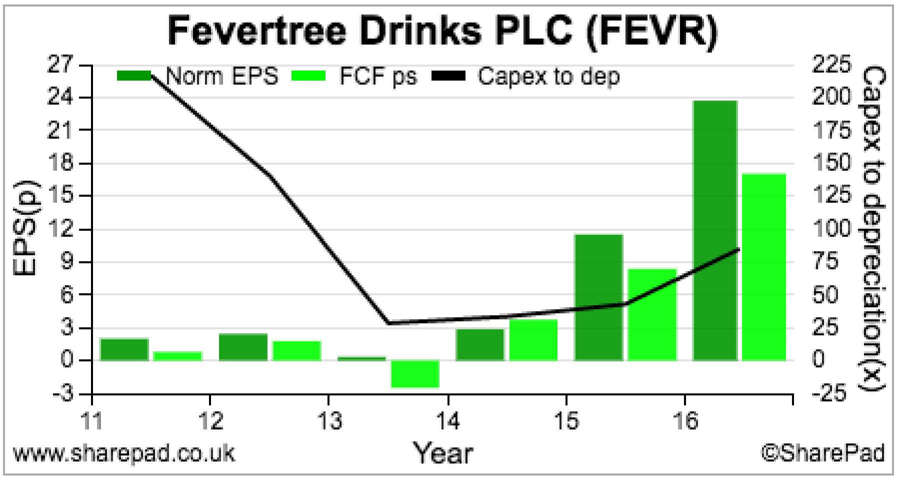
Its 2016 financial results announced this week revealed another year of exceptional progress. Sales were up by a stonking 73% with higher profit margins to boot. EPS more than doubled to 23.7p whilst net cash balances increased from £11.6m to £26.9m.

Fevertree's premium mixer drinks are clearly gaining in popularity with people and it is no surprise that more retailers, hotels and airlines want to sell its products. When this strong demand is combined with an outsourced manufacturing model - the drinks are made and bottled by third parties- it is possible to generate outstanding returns on capital employed (ROCE) and prodigious free cash flow.

ROCE took a big step forward in 2016 and is now over 40%. This is a sign of an exceptionally profitable business.



Free cash flow per share surged as well but again was less than its EPS. More on this shortly.



There is a lot to like about this company. With its main bottling partner doubling its UK capacity in 2016, Fevertree clearly has the ability to keep on growing. In addition to its very popular existing drinks it has a strong product development pipeline in order to generate future sales and profits growth.

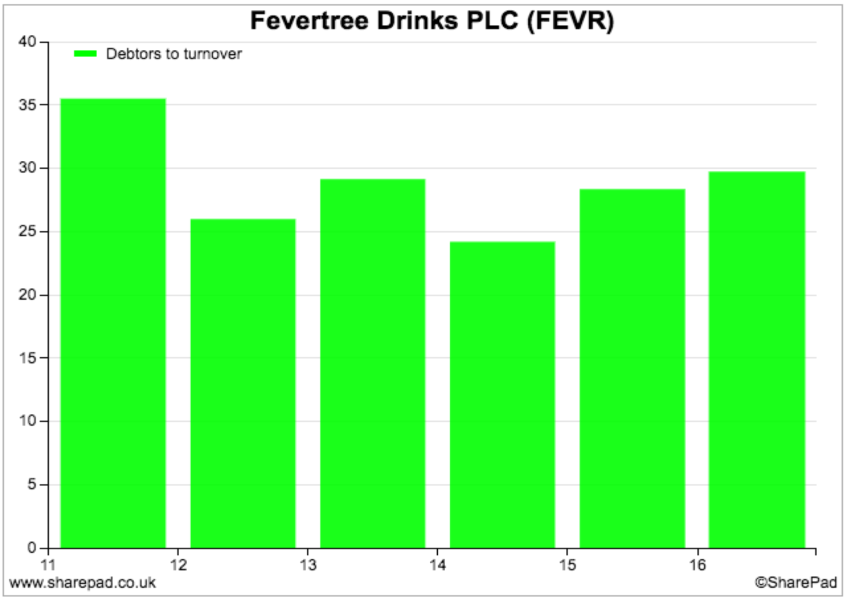
I don't have any major worries about this company at the moment, but if you asked me to be a bit picky and point any possible concerns I would focus on the following three:

Firstly, I thought the outlook statement was a bit lukewarm.

"We have had an encouraging start to 2017 and remain confident that we are increasingly well positioned to deliver further growth across the business."

I think that the rally in the share price in recent weeks may have been in anticipation of more big profit forecast upgrades as was seen in January. These have not materialised.

Secondly, the ratio of debtors to sales has been increasing. This can be a sign that a company is overtrading - offering increased credit to customers in order to boost sales and profits - or even manipulating profits.



I don't think this is happening at Fevertree. The company has given an explanation of this in its accounts and is not trying to duck the issue:

"The level of working capital held at year end included elevated levels of trade receivables (91% increase on 2015), which is largely due to the very strong trading performance in December in the UK. Despite the build in trade receivables at year end, operating cash flow remains strong at 72% of adjusted EBITDA, with significant cash balances to be collected in 2017."

I read into this that the increase in receivables could reverse out in 2017 - depending on the rate of sales growth - with cash flowing into the business when the current outstanding bills are paid.

Thirdly, the valuation remains very high at over 55 times 2017 expected earnings. This is a little bit concerning given that earnings growth is expected to be quite modest at less than 10%.

Fevertree Drinks PLC (FEVR)

← Prev Next →	2013	2014	2015	2016	2017	2018
Fiscal period ending	31/12/13	31/12/14	31/12/15	31/12/16	1/12/17	1/12/18
£ millions unless stated	Q4	Q4	Q4	Q4	Forecast	Forecast
KEY FORECASTS						
Turnover	20.6	34.7	59.3	102.2	119.0	132.2
Turnover %chg	▲26.6	▲68.6	▲70.8	▲72.5	▲16.4	▲11.1
EBIT	5.0	9.2	17.3	34.4	-	-
EBIT margin	24.4	26.5	29.1	33.6	-	-
EPS(p)	0.3	2.9	11.5	23.7	25.7	27.4
EPS % chg	▼-86.0	▲744.1	▲300.0	▲106.4	▲8.4	▲6.6
DPS(p)	0.3	0.3	3.1	6.3	6.4	6.9
DPS % chg	-	▼0.0	▲926.7	▲102.9	▲2.4	▲7.8
Dividend cover	1.1	9.6	3.7	3.8	4.0	4.0

The high valuation leaves very little room for disappointment. If earnings growth disappoints then Fevertree shares could fall heavily.

My view is that the current very high valuation of the shares cannot be supported by expectations for future profits growth alone. The company has increasing value as a scarce asset with a portfolio of premium products which big drinks companies are struggling to compete with. Instead of developing their own premium mixers it may just be easier to buy Fevertree instead.

Bellway (LSE:BWY)

Life is good for housebuilder Bellway and its shareholders. Its home sales and share price are both at record highs.

This week saw the company post a very strong set of half year results. Sales were up 5.9% on the back of a 6.5% increase in the number of homes sold. Profit margins were higher as house price inflation continued to outpace the rise in building costs. EPS increased by 10.3%.

The outlook for the year to June 2017 is also encouraging. The value of the forward order book is 18% higher than a year ago with the company to sell 5% more homes at a selling price of £260k compared with £252.7k in 2016. Profit margins are expected to be maintained at 22%.

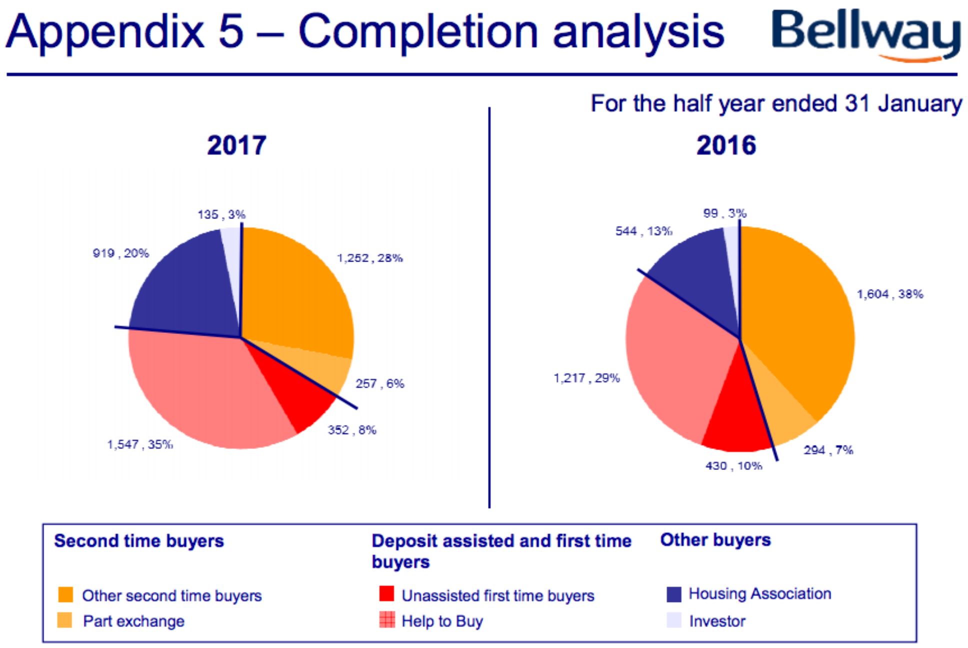
Unlike some of its peers, Bellway is not paying large special dividends as it is using its financial strength to buy more land which meet its ROCE hurdle rates.

Despite Bellway's and its peers' strong profit performance I retain my concerns about the company and the sector for the following reasons:

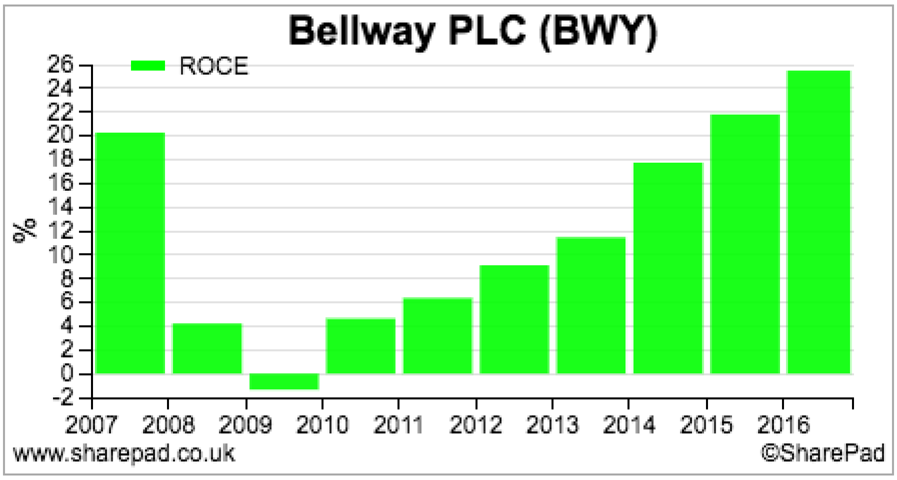
Firstly, I see UK house prices as overvalued and increasingly unaffordable. This is why the government is subsidising the mortgage market with its Help to Buy equity loan scheme. I think housebuilders are too dependent on this scheme to sell the houses that they are building.

The proportion of homes Bellway has sold using Help to Buy has increased from 29% to 35% during the last year. 37% of the forward order book is from Help to Buy reservations.

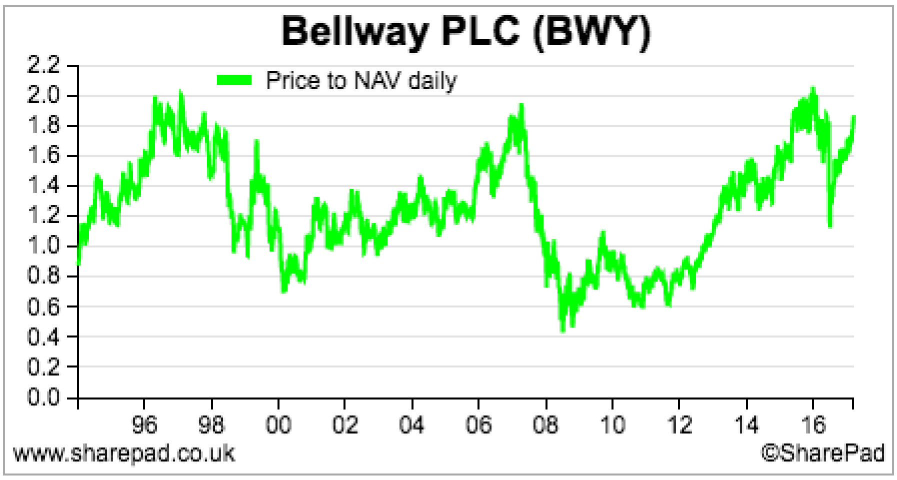
The government has said that Help to Buy will stay in place until 2021. The key issue for builders and their profits is what happens after 2021? If the government does not prop up the market then how will people buy a large chunk of builders' homes? Will banks give 95% loan to value mortgages?



Secondly, profitability is at an all time high. ROCE may continue to climb but it is fair to say that we are nearer the top of the profit cycle than the bottom. Profit margin growth looks like it will become harder to achieve as house price inflation moderates and building costs increase.



Finally, valuations as measured by price to net asset value (P/NAV) is close to all time highs.



I'm not saying that Bellway shares are going to fall a long way. However, with a heavily subsidised housing market, high profits and high valuations, I think the easy money has been made here.

Filter of the week - shares which might run out of upwards momentum

We have just updated our filter library in SharePad and have added lots of new filters. I tend to spend most of my time analysing company fundamentals such as profits and cash flows.

This week's filter is based on a very popular technical analysis indicator called the Relative Strength Index or RSI for short. RSI tries to identify shares that are overbought or oversold and is a measure of share price momentum.

In simple terms an RSI above 70 suggests a share might be overbought and due a fall. An RSI below 30 might suggest a share is oversold and due a bounce.

This filter looks for shares which have crossed above 70 on the daily RSI in the last trading day (so the results will change every day).

Filtered FTSE All-Share sorted by Price % from close (6 matches)

RSI cross above 70

☑ RSI(20) cross above 70 [1]

No.	TIDM	Name	RSI(20) cross above 70 [1]	RSI(20)
1	ELTA	Electra Private Equity PLC	✓	70.6
2	GVC	GVC Holdings PLC	✓	72.0
3	HSTG	Hastings Group Holding...	✓	71.6
4	NG.	National Grid PLC	✓	70.5
5	PAYS	Paysafe Group PLC	✓	71.4
6	REL	RELX PLC	✓	70.3

With technical signals like this, it is always best to look at the chart history to see if this has been a reliable signal for the share in question or if the share has reached a recent high on the RSI scale. It can also show you how much the share price retraces, if at all, when RSI reaches this level.

Here are some ideas on how to modify this filter:

1. If you are looking for trading ideas, you could try applying this filter to the indices list or foreign exchange.

2. To filter out the "noise" of daily price movements, you could change the filter to use monthly RSI values.

3. You could also relax the criteria to look for crosses above 70 in the previous five trading days for example.