Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

21st April 2017

Market overview

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
FTSE 100	7120.59	▼-2.82	▼-4.16	▼-0.311	▲11.1	7429.81	5923.53	20/3/17	14/6/16
FTSE 250	19377.1	▼-0.759	▲1.18	▲7.19	▲13.9	19525.3	14967.9	13/4/17	27/6/16
FTSE SmallCap	5450.77	▼-0.608	▲0.731	▲5.98	▲17.5	5484.14	4272.07	13/4/17	27/6/16
FTSE AIM 100	4635.2	▲0.0533	▲2.52	▲13.9	▲34.5	4635.2	3188.77	20/4/17	27/6/16
S&P 500	2348.23	▲0.828	▼-1.06	▲4.89	▲11.7	2395.96	2000.54	1/3/17	27/6/16
UK Treasury 10 Year Par Yield	1.03	▼-0.962	▼-14.9	▼-18.9	▼-32.2	1.72	0.61	26/4/16	12/8/16
Brent Oil Spot $	$53.005	▼-4.74	▲2.51	▼-6.61	▲16.3	$56.965	$41.965	29/12/16	2/8/16
Gold Spot $ per oz	$1281.67	▼-0.476	▲3.8	▲11.4	▲2.91	$1366.48	$1128...	6/7/16	15/12/16
GBP/USD - US $ per £	1.283	▲2.6	▲3.75	▲4.47	▼-10.5	1.47895	1.20401	22/6/16	16/1/17
GBP/EUR - Euros per £	1.19125	▲1.12	▲3.42	▲1.43	▼-6.08	1.3174	1.1066	25/5/16	13/10/16

I don't usually talk that much about the markets but this week I will as there has been a lot going on. First and foremost has been the announcement that there will be a snap UK General Election on June 8th. I think most people were surprised by this but what does it mean for your investments?

Generally speaking, I think that investors should ignore much of what goes on in politics and focus on the long-term prospects of individual companies. I still think that is the best course of action. However, I think that upcoming political events have the potential to put downwards pressure on share prices.

I am a keen follower of the UK political scene but do not consider myself to be an expert. That said, I wouldn't want to be seen as one as the experts have a terrible recent record in predicting events. All I can say is that I won some money betting on a Conservative majority at the last election and that the UK would vote to leave in last year's EU referendum. But my guess on what will happen is as good as yours.

The general consensus is that the Conservatives could win a landslide victory with a very large majority. This may come to pass but other scenarios are possible. For example, if the election becomes a re-run of the referendum campaign then it is possible that the Lib Dems - as the only pro EU party - could pick up seats after a disastrous result in 2015. If that comes at the expense of the Conservatives then a hung parliament is not unthinkable as many Conservative and Labour seats are considered safe.

Why does this matter? Well, it could have a significant impact on the value of the pound. The pound has already rallied strongly in the last month and has made gains against the dollar and the euro this week. These moves are not yet big enough to change expectations of average yearly exchange rates which analysts use to forecast overseas profits converted back into pounds but the risk is there. The pound seems to have upwards momentum at the moment.

Many shares in the FTSE 100 earn the bulk of their profits overseas. They have had a significant boost to their profits and profit forecasts because of the devaluation of the pound since last summer. Smart investors will have taken this into account but in some cases, this boost to profits has masked very modest rates of underlying sales and profits growth. If the election result changes expectations of the UK's exit path from the EU and causes the pound to appreciate then the FTSE 100 may struggle to make much progress and it could pave the way for some heavy share price falls.

The other political event to be aware of is this weekend's first round of the French presidential election. The polls are predicting a very tight four-way battle. The worse case scenario for the markets is a second round runoff between the hard right candidate (Le Pen) and the hard left (Melenchon). Both candidates want to take France out of the euro. If this scenario materialises on Sunday evening then expect carnage on the markets on Monday morning.

I will not let any of these political events worry me. In fact, a fall in share prices could produce some very good buying opportunities as was seen on June 24th last year. It should be an interesting week.

Top 10 FTSE All-Share winners

No.	TIDM	Name	%chg 1w
1	COB	Cobham PLC	▲9.08
2	UAI	U and I Group PLC	▲8.28
3	BMS	Braemar Shipping Services PLC	▲7.96
4	LWB	Low & Bonar PLC	▲7.45
5	KNOS	Kainos Group Ltd	▲7.03
6	EZJ	easyJet PLC	▲6.02
7	CMCX	CMC Markets PLC	▲5.13
8	BWNG	Brown (N) Group PLC	▲4.89
9	RBS	Royal Bank of Scotland Group (Th...	▲4.86
10	ACL	Acal PLC	▲4.81

Top 10 FTSE All-Share losers

No.	TIDM	Name	%chg 1w
1	ACA	Acacia Mining PLC	▼-15.4
2	ENQ	EnQuest PLC	▼-11.7
3	TLW	Tullow Oil PLC	▼-10.2
4	BRBY	Burberry Group PLC	▼-9.7
5	HOC	Hochschild Mining PLC	▼-8.71
6	GEMD	Gem Diamonds Ltd	▼-8.07
7	LMI	Lonmin PLC	▼-7.59
8	LAM	Lamprell PLC	▼-7.59
9	FRES	Fresnillo PLC	▼-7.56
10	HTG	Hunting PLC	▼-6.95

Share Discussion: Connect Group (LSE:CNCT)

Connect Group (previously known as Smiths News) was spun off from WH Smith just over a decade ago. Its core business of delivering newspapers and magazines to retailers has been in decline for some time now but the company has done a good job in doing the job more efficiently and preserving a decent level of profitability.

In order to try and create some growth in profitability, the company has reinvested the cash flows from its news distribution facilities into complementary logistics activities such as books and parcels. At the same time it has been able to pay a modestly growing dividend to its shareholders every year.

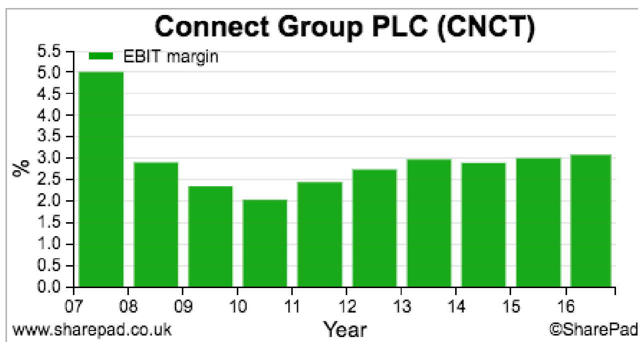
However, its struggle to produce any meaningful profits growth in the last few years has weighed heavily on its share price. The valuation of the shares is just 6.7 times 2017 EPS according to

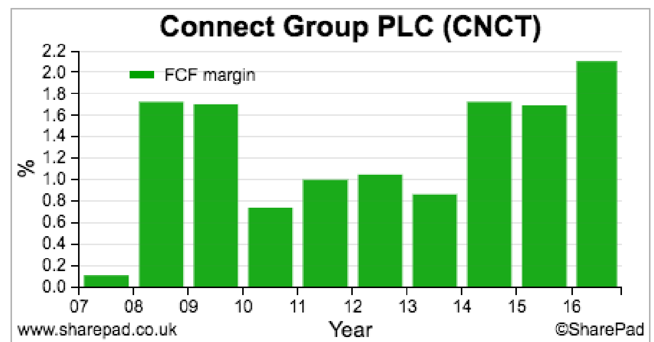
SharePad with a prospective dividend yield of 7.4% which is well covered by profits.

This is the kind of low valuation which understandably attracts investors, but the lacklustre share price over the last couple of years suggests that there are grounds for considering whether Connect Group is a classic value trap - a share that is cheap because it has poor prospects.

Despite trying to develop alternative profit streams, the company remains very reliant on the profits from its news distribution business. Profits here have been around £40m for the last five or six years. Even though newspaper circulations have been falling, Connect gets paid a percentage of the cover price which has been rising. This and a relentless focus on efficiency has maintained profits.

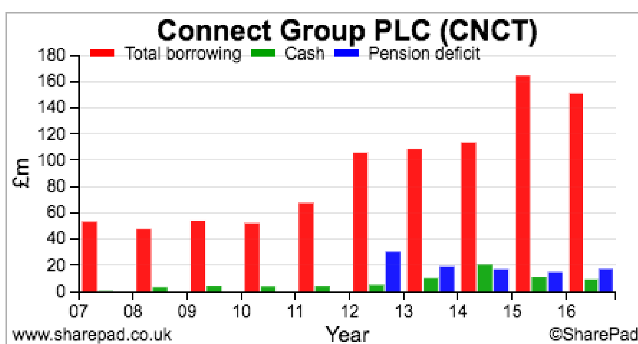
That said, the Connect Group operates on wafer thin margins. EBIT margins are around 3% and free cash flow margins are just over 2%.

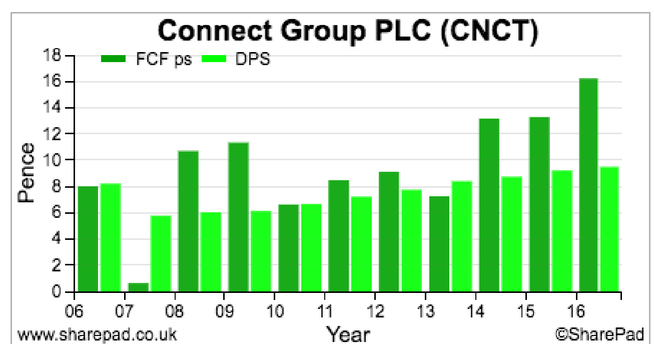




It would not take much of a setback to really hurt this company's profitability.

Borrowing levels are also quite high and there is a small pension fund deficit as well. In 2016, the fixed charge cover ratio was a very comfortable 2.4 times and interest cover was just under 10 times. This is not a company in any imminent danger of getting into financial difficulties.





The key investment attraction of Connect is its high dividend yield. As you can see from the chart below, the company has been producing more than enough free cash flow to pay a rising dividend.

This brings us back to the key issue with the shares: Why are they so cheap? Why is the market so pessimistic? After all, at the moment, it seems very difficult to see how the dividend is going to be cut anytime soon.

I think it's fair to assume that sooner or later it will become more difficult to keep on wringing cost savings out of the news distribution business and that there is a chance that profits could decline sharply from this source.

The company has also just sold its educational books and stationery business for £56m and a

reduction of £7.9m in the pension liability. This will reduce debt and the pension fund deficit but this division made £7.8m in trading profits in 2016 so by selling it Connect will see its EPS and free cash flow decline. That's because the reduction in interest payments on borrowings will not offset the loss of trading profits.

So the company needs to find additional sources of profits growth. Its books delivery business for retailers and libraries is struggling so it needs to look elsewhere.

One source is its Parcel Freight business which trades as Tufnells Parcels. This business made £15m of trading profit (EBIT) last year on sales of £174.m (a margin of 8.6%) and has carved out a profitable niche specialising in bulky and irregular shaped deliveries for businesses. This business is trading well and is securing new contracts but it does require a significant amount of maintenance investment which will reduce its free cash flow in the short-term.

The other interesting potential source of growth comes from the Pass My Parcel (PMP) business. This is focused on the rapidly growing click and collect market and taps into the logistics expertise of the news distribution business.

Timely and convenient delivery and returns have become an important part of retailers' internet businesses which requires an efficient logistics operations. Connect has already established a network of 3000 parcel shops and has secured contracts with strong customers such as Amazon and Asos. The company is expecting strong growth to continue and investing heavily to support this.

PMP lost £4m in 2016 and the loss is expected to narrow to £2.5m in 2017. Should the scale of the business continue to ramp up then it is possible that this business could become a new source of profits for Connect.

There is competition in this space. PayPoint (LSE:PAY) has a joint venture with Yodel called Collect + which is currently bigger than PMP in terms of outlets served. It too has yet to make any meaningful profits from click and collect deliveries and returns.

Connect also has an interesting digital books business called Wordery which is an alternative to Amazon's Kindle. It is possible that this business could have some meaningful value for shareholders if it is sold in a few years' time.

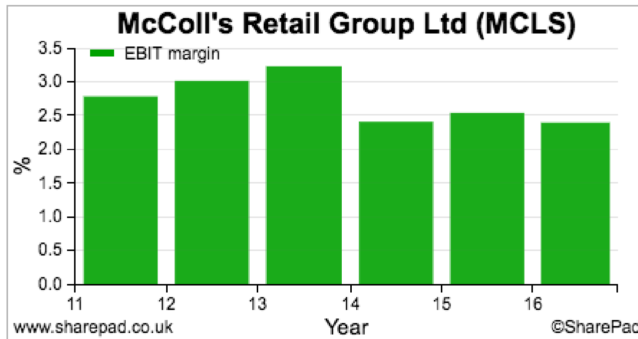
I see a reasonably tough future for Connect. It will have to work very hard for its profits. However, it is not a basket case by any means. Sure, the shares may be volatile but if you were looking for a 7% income return that looks reasonable safe for the next few years then the shares might be worth a look.

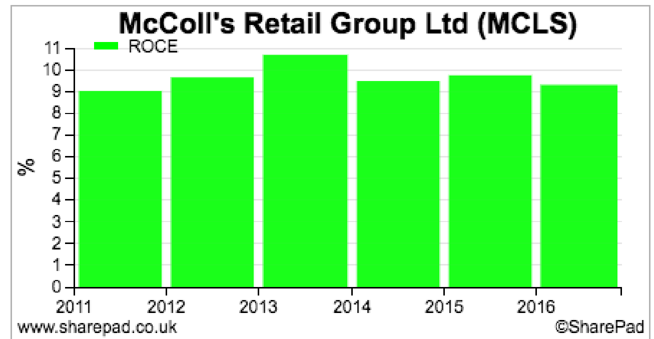
Share Discussion: McColl's Retail Group (LSE:MCLS)

Convenience store operator McColl's could be another interesting yield candidate for investors to consider.

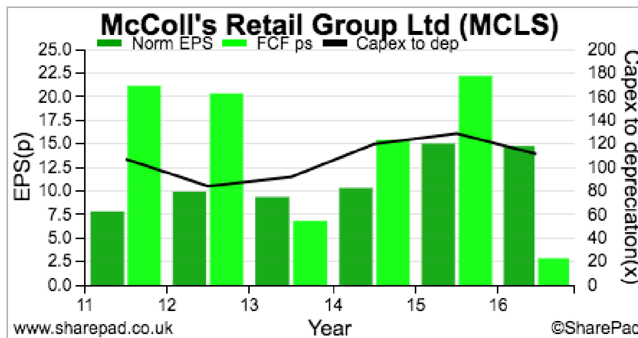
Generally speaking I would not consider investing in a food retailing company. Competition is cut-throat, whilst profit margins and ROCE tend

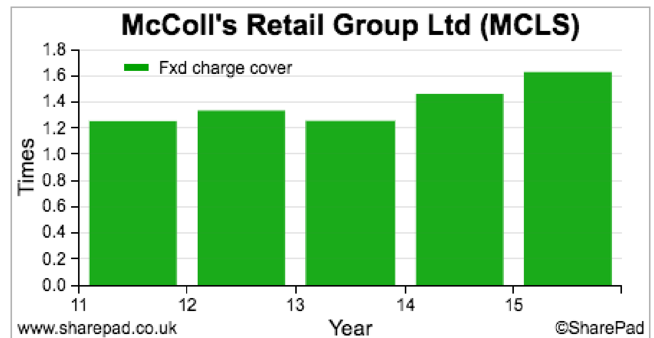
to be low. In fact, margins and ROCE (adjusted for its rented shops) are very modest at McColl's as shown below.





However, the company does have some desirable characteristics as well. Generally speaking, it is good at turning its profits into free cash flow. 2016 was an exception to this due to a working capital outflow relating to acquisitions and the reversal of benefits from 2015. I do not expect meaningful working capital outflows to continue as food retailers generally turn their stocks into cash before they have to pay their suppliers and don't tend to sell on credit.





The company rents rather than owns its shops but fixed charge cover is comfortable at over 1.6 times.

McColl's shares have been on a very strong run since last summer but there are grounds for thinking that there could be more to come from them.

Certainly, this is a business that faces challenges in terms of competition and things such as rising wage inflation on thin profit margins. However, there are ongoing developments within the business that are positive in my view. More on this shortly.

Convenience stores have been a growth area and look set to play an important part in people's' shopping habits in the future. Rising levels of urban congestion and the growth of internet grocery shopping have hurt the big supermarket chains. But people have increasingly shopped in convenience stores in order to top up their weekly shops - such as picking up a loaf of bread or bottle of wine. Tesco and Sainsbury's have invested heavily to exploit this trend and are doing well from it.

McColl's is also well placed to do well. It has over 1000 convenience stores and has the potential to benefit from self-help initiatives as well as the resilience of the market in general.

The company has been improving the quality of its store estate. Over half of them have important attractions such as Post Offices in them. McColl's has also been adding more reasons for people to visit them such as Amazon lockers.

There has been a big push on converting the stores away from traditional newsagents and corner shops to more upmarket food and wine shops with fresh food (including the addition of Subway franchises). The company has also sold 97 newsagent stores. This has been seen in an improving trend in like-for-like sales. They were still negative to the tune of 1.3% during the first quarter but the trend has been improving for the last year.

Then there is the purchase of 298 profitable convenience stores from the Co-op for £117m last year. All these shops will be fully converted and up and running by August this year. This is a transformational deal for McColl's and will bring benefits such as improved buying power with suppliers. It is also expected to deliver strong growth in earnings.

McColl's Retail Group Ltd (MCLS)

Key	Name	Forecast	Confirmed	Opinion	Target price
(blue)	Numis Securities Ltd	27/2/17	18/4/17	Buy	2.25
(orange)	Peel Hunt LLP	17/3/17	6/4/17	Buy	2.40
(black)	Consensus	21/3/17		Under Perform (2) ℹ	2.33

ℹ The actual number of estimates used to calculate the consensus opinion

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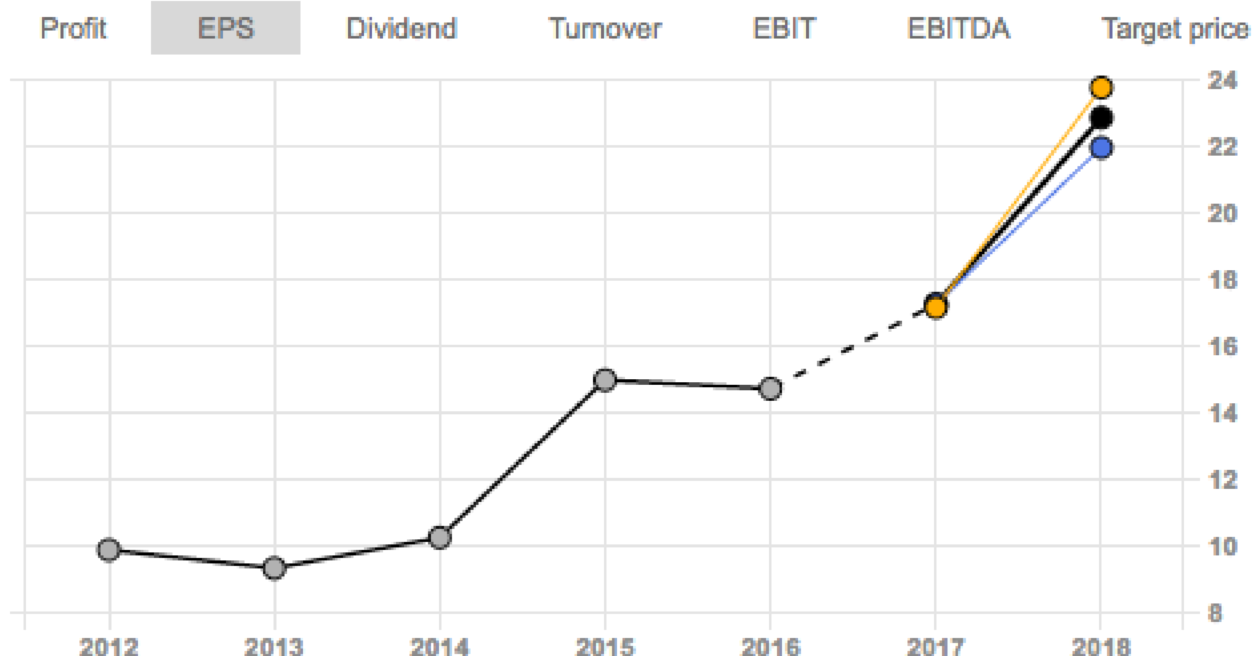
Key	Name	Profit	EPS	Dividend	Turnover	EBIT	EBITDA
(blue)	Numis Securities L...	31.3	22.0	11.0	1257.0		54.5
(orange)	Peel Hunt LLP	34.5	23.8	11.5	1310.6		60.5
(black)	Consensus	32.9	22.9	11.3	1284.0		57.5



Analysts are forecasting EPS of around 23p for the year to November 2018. This puts the shares on a 2018 PE of 8.6 times and a yield of 5.7% at the current share price of 198p. Possibly another share for readers to do more research on.

Share Discussion: STV Group (LSE:STVG)

Continuing the theme of small-cap yield stocks this week is STV.

STV can be loosely summed up as the Scottish equivalent of ITV (it owns the ITV franchise in Scotland). Whilst there has been a lot of chatter about whether ITV will be taken over and the long-term prospects for its advertising revenues, STV has been quietly chugging away.

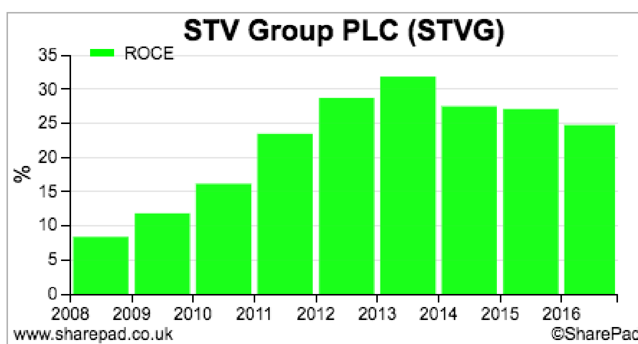
Like its much larger peer, the company's fortunes are closely tied to TV advertising revenue which remains under pressure from alternative media sources. The company also derives revenue - but not much profit - from making TV programmes and has revenues from digital advertising.

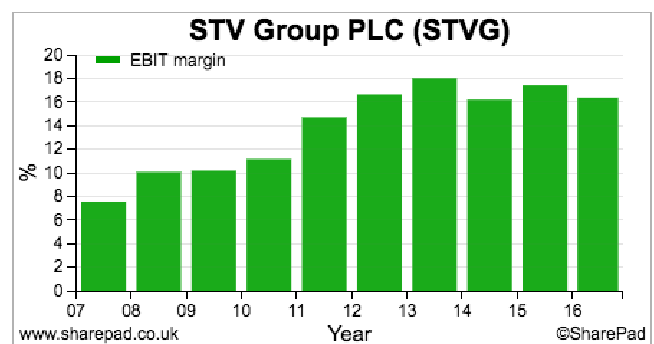
2016 was a tough year with sales and profits broadly flat. 2017 has not started well with advertising revenues down significantly. Despite this, STV remains the most popular commercial TV station in Scotland and still retains significant commercial appeal for advertisers. It has just entered a new eight year programme scheduling agreement with ITV which also takes a lot of uncertainty away from the business. The company will also launch a new channel called STV 2 next Monday (24th April).

I think that STV could be another interesting share for income seekers to consider.

Despite a volatile and uncertain advertising market, the company remains highly profitable and cash generative. ROCE has been coming down but was still 25% last year.

Profit margins remain high too at 16% and have remained relatively stable for the last 5 years.





What has made the company more interesting from an income point of view is the big hike (50%) in the dividend in 2016. The company has a new policy of paying out between 60-80% of its free cash flow after pension deficit top up payments.

After a 15p dividend in 2016, analysts are expecting a rise to 17p in 2017 and 18p in 2018. This puts the shares on a prospective yield of 4.6% and is expected to be over twice covered by earnings. The forecast PE is 9.2 times.

My only concern - and quite a big one at that - is how this company can meaningfully grow its profits in the future. Unlike ITV it does not have a big and highly profitable in-house content business nor a large digital advertising base. I can see it becoming a steady and unexciting cash cow with a big dividend.

I fully understand that might not be enough to entice investors. I also don't see STV as a takeover candidate but could be wrong. ITV bought Ulster TV in 2015 but I don't see it as a buyer of STV having sold its stake in the business in 2013.

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