Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

5th May 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	7250.05	▲0.178	▼-0.98	▲1.5	▲18.6	7429.81	5923.53	20/3/17	14/6/16
FTSE 250	19674.1	▲0.191	▲3.44	▲8.83	▲18.1	19805.3	14967.9	2/5/17	27/6/16
FTSE SmallCap	5551.98	▲0.7	▲2.86	▲7.95	▲22.2	5568.5	4272.07	2/5/17	27/6/16
FTSE AIM 100	4768.01	▲0.661	▲4.51	▲17.1	▲41.2	4776.18	3188.77	2/5/17	27/6/16
S&P 500	2388.5	▼-0.0113	▲1.2	▲6.69	▲16.4	2395.96	2000.54	1/3/17	27/6/16
UK Treasury 10 Year Par Yield	1.1	▲2.8	▲4.76	▼-13.4	▼-30.4	1.58	0.61	4/5/16	12/8/16
Brent Oil Spot $	$49.095	▼-5.7	▼-9.53	▼-13.5	▲9.29	$56.965	$41.965	29/12/16	2/8/16
Gold Spot $ per oz	$1229.03	▼-2.78	▼-2.12	▲6.82	▼-4.19	$1366.48	$1128...	6/7/16	15/12/16
GBP/USD - US $ per £	1.29087	▲0.126	▲3.77	▲5.11	▼-11	1.47895	1.20401	22/6/16	16/1/17
GBP/EUR - Euros per £	1.1799	▼-0.565	▲1.29	▲0.468	▼-6.51	1.3174	1.1066	25/5/16	13/10/16

The week on the stock markets has been relatively quiet. We have seen a sharp fall in the price of oil which looks like it is stuck in quite a weak phase just now. There is no real sign of a price recovery back to the levels seen just a few weeks ago and it would be no surprise to see continued weakness. That said, trying to predict the oil price is impossible with even the professionals failing to predict the spike of 2008, its subsequent collapse and the falls of just over a year ago.

2017 is shaping up to be the year of AIM which is trouncing the performance of its main market peers. There have been some terrific gains posted by small mining and oil companies which have played a large part in AIM's rise to date.

The pound has also crept higher against the dollar and has now appreciated by 5% so far this year. This is a number that investors should keep a keen eye on, especially if they own companies with lots of overseas earnings.

Many companies have seen their profits flattered by the devaluation of the pound (as it increases the sterling value of overseas profits when they are translated back into pounds) and masks quite modest - or even weak - underlying growth. A continued rise in the value of the pound would see profit forecasts cut which could put some share prices under pressure.

The other indicator that continues to amaze me is the yield on 10 year UK government bonds of just 1.1%. Of course, this is not a true picture in many respects as yields have been kept low by Bank of England money printing. But inflation has been creeping up which means that the real cost of borrowing is negative and this may be feeding through to an overdose on cheap credit by consumers.

Over the last 30 years, yields on 10 year gilts have averaged nearly 3% more than inflation. Can you imagine yields of 5-6% today and the effect that would have on the housing market and the economy? The government and Bank of England is very aware of this and that is why I think interest rates will stay low for a very long time to come.

Top 10 FTSE All-Share winners

No.	TIDM	Name	%chg 1w
1	MTO	Mitie Group PLC	▲13.9
2	SEPU	Sepura PLC	▲13.2
3	BWNG	Brown (N) Group PLC	▲12.1
4	OXIG	Oxford Instruments PLC	▲11.8
5	ESUR	esure Group PLC	▲9.59
6	CHOO	Jimmy Choo PLC	▲9.58
7	CMBN	Cambian Group PLC	▲9.47
8	OXB	Oxford BioMedica PLC	▲8.68
9	NMC	NMC Health PLC	▲7.8
10	RSW	Renishaw PLC	▲7.67

Top 10 FTSE All-Share losers

No.	TIDM	Name	%chg 1w
1	CEY	Centamin PLC	▼-13
2	GFRD	Galliford Try PLC	▼-11.6
3	KAZ	KAZ Minerals PLC	▼-10.8
4	VED	Vedanta Resources PLC	▼-10.7
5	VM.	Virgin Money Holdings UK PLC	▼-9.77
6	ALM	Allied Minds PLC	▼-8.32
7	AAL	Anglo American PLC	▼-8.26
8	GMD	GAME Digital PLC	▼-7.97
9	ANTO	Antofagasta PLC	▼-7.82
10	LMI	Lonmin PLC	▼-7.57

Share Discussion: JD Wetherspoon (LSE:JDW)

Regular readers of my articles will know that I am not really a fan of investing in pubs. I tend to prefer companies which generate higher returns on capital employed (ROCE) and are less capital intensive. That said, it's just my own personal preference; I don't think they are terrible businesses at all and it is possible for investors to make money from them.

Twenty years ago, my first professional analyst job was looking at the pubs and brewing sector. I did this full time for the next two and a half years before becoming a transport analyst. It is a fascinating sector and one that I have kept an eye on ever since.

I spent a lot of time visiting pubs, talking to management and analysing the financial performance of pub companies. My view then was that it is very hard to make consistently good money from running pubs. It still is.

The industry is fiercely competitive and asset intensive. Companies need to keep their pubs looking nice so that they are attractive to customers and the sales are maintained. Money spent on doing this is money that cannot be paid to shareholders.

Growing the underlying sales of pubs is also quite hard. To grow profits, companies often have to spend money opening up new pubs. This in turn makes the business more difficult to manage as it gets bigger but does bring benefits in terms of better buying terms for food and drink which can enhance profit margins.

Some parts of the pub estate - mainly newer and well-invested pubs - perform better than other parts which are older and perhaps less well-invested. The poorly performing pubs are referred to as the tail of the estate and are often sold.

Getting rid of the underperforming tail is much easier for pub companies with freehold properties than those tied into long-term rent agreements or leaseholds. Freehold pub estates do consume more cash flow than leaseholds and tend to lead to significantly higher levels of balance sheet debt.

Freeholds can be sold to free up substantial amounts cash which can be paid out to shareholders or reinvested in more attractive new pubs. One of the attractions of some freehold pub companies is that there can also be some hidden property value not disclosed on the balance sheet.

So whilst the ROCE from running pubs is quite modest, there can be a silver lining in the form of additional property value when the economy and property market is good. When times are bad though, those freehold property values might have to be written down in value. All in all, if I was going to invest in this sector my preference would probably be for freehold pubs for the flexibility (ability to sell and extend) and asset backing that they bring as I think it is a less risky proposition than investing in leaseholds.

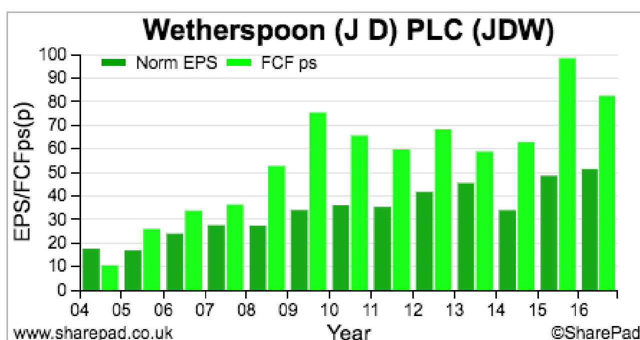
Over the last 20 years, pub companies have had to put up with the ups and downs of the economy, increased competition from supermarkets, the smoking ban, higher taxes, rising wage pressures and the excess debt secured against tenanted pubs to name a few. This has made many pub companies poor long-term investments.

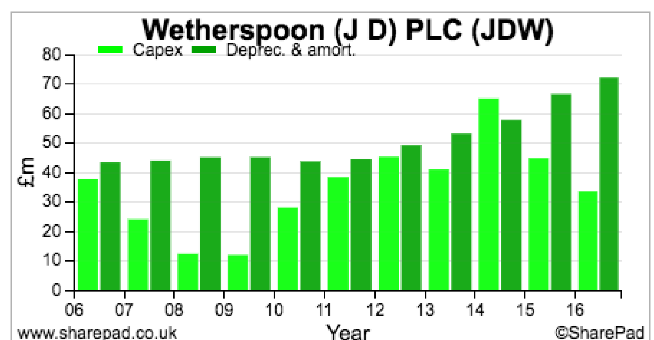
The best performers by some margin have been the London and south of England focused companies such as Fuller, Smith & Turner (LSE:FSTA) and Young & Co (LSE:YNGA). The other notable performer has been JD Wetherspoon (LSE:JDW).

Wetherspoon has adopted a very successful business model of offering drinks and food at very affordable prices in pleasant surroundings. The company prides itself in keeping its pubs in excellent condition.

The company's profit margins are quite low by industry standards at just under 8% as it relies more on volume than price to make its money. Mitchells & Butlers (an appropriate comparable company as it does not have a brewing arm and therefore a transfer pricing agreement with its pubs business) makes over 15%.

Wetherspoon has produced steady growth in profits over the last decade or so with the odd hiccup. Its free cash flow per share (after deducting maintenance capex only) has also been impressive and considerably more than EPS.



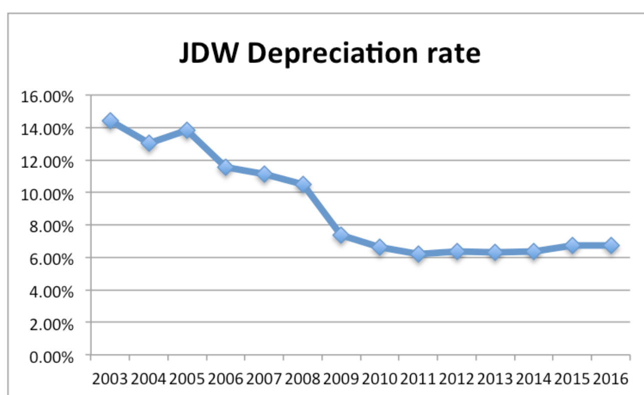


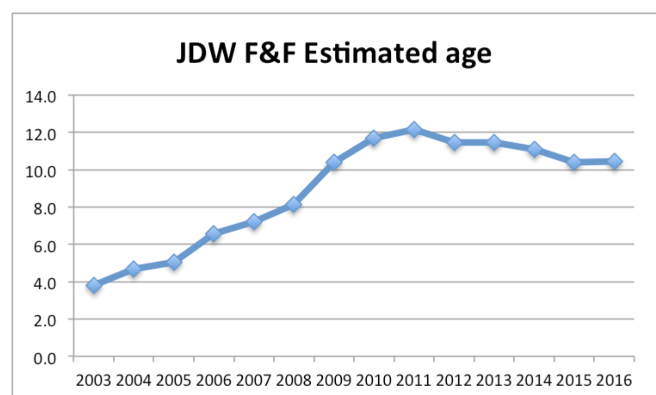
If you are looking at Wetherspoons on a PE basis then the shares can look quite pricey. If the free cash flow per share is a believable number then the trailing P/FCF multiple at a share price of 1038p is 12.6 times compared with a trailing PE ratio of 20.2 times.

As you can see from the chart above, Wetherspoon's maintenance capex is typically less than depreciation - and was substantially less in 2015 and 2016 and is the main reason why free cash flow per share is more than EPS.

This intuitively does not make sense unless depreciation is very prudent. Depreciation is a real cost for pubs as fixtures and fittings have to be replaced. As I wrote a few weeks ago when discussing the issue of pub depreciation (click here) this used to be the case for Wetherspoon but I do not think that's the case now.

Wetherspoon used to have a very prudent depreciation policy on its fixtures and fittings as shown in the chart below but less so now.





Its assets have become older and my guess is that it has a reasonable chunk of assets that are fully depreciated and not reducing profits.

Does this mean that Wetherspoon's profits are overstated due to assets being under depreciated? Maybe, maybe not.

One way to spot potential under-depreciation is the reporting of losses on disposal of assets. This happens when sales proceeds are less than the carrying value of assets on the balance sheet. The company made £8.5m of losses in 2016 and a further £6.6m during the first half of 2017. This suggests that these assets were under depreciated.

In Wetherspoon's defence is the fact that it spends significant amounts of money on repairs and maintenance every year, averaging just over 3.5% of sales (£54.9m in 2016), and it has remained constant at around this level for many years. These costs are expensed against revenues and reduce profits. It is therefore possible that the company is prolonging the lives of certain fixed assets by repairing them rather than replacing them.

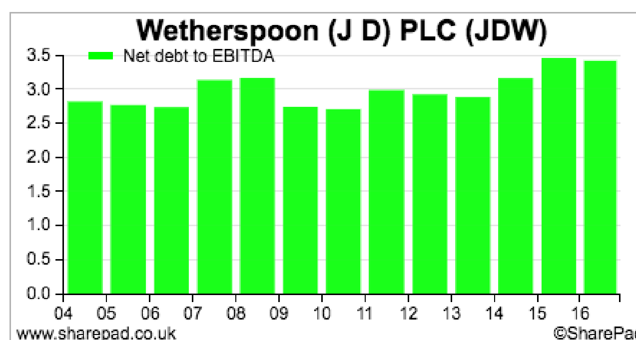
JDW (£m)	Repairs (£m)	Sales (£m)	Repairs as % of Sales
2007	34.1	888.5	3.84%
2008	30.6	907.5	3.37%
2009	29.8	955.1	3.12%
2010	35.4	996.3	3.55%
2011	38.4	1072	3.58%
2012	46.6	1197.1	3.89%
2013	48	1280.9	3.75%
2014	59.4	1409.3	4.21%
2015	53.4	1513.9	3.53%
2016	54.9	1595.2	3.44%

However, it is difficult as an outsider to know whether Wetherspoon has a depreciation problem or not without visiting over 900 pubs. If I am being harsh I'd say that it looks as if depreciation is a little bit light and that profits could be a little bit overstated but not by massive amounts. The depreciation ratio has started to rise again as old assets are replaced which is a good sign.

As I've argued before, the problem with comparing maintenance capex with depreciation is that maintenance capex applies only to the assets in pubs where it is spent whereas depreciation applies to all the assets in all the pubs.

I'll leave you to dwell on this issue - if you want to - but my view is that Wetherspoon should be valued on its profits and earnings - where depreciation is expensed - rather than on free cash flow after maintenance capex.

Wetherspoon is what I call a halfway house in terms of the pub sector. Just over half its pubs are owned (51.4%) with the rest leased. The company has been spending a lot of money in recent years buying itself out of leaseholds - to give it flexibility to extend pubs and add hotel rooms - and this is one of the reasons why its debt levels have been going up slightly relative to profits. The other is the continued buyback of shares.



As profits have been rising, net debt to EBITDA is not uncomfortably high at 3.5 times but the company has commented that it does not really want to see debt go much higher on this measure.

I would expect Wetherspoon to keep on gradually increasing the freehold proportion of its pub estate in the years ahead which would be a welcome development for shareholders in my view.

One of the things I really like about Wetherspoon is its ability to consistently increase sales from its existing assets - to increase its like-for-like sales. This is a hallmark of a decent business, especially in a very competitive sector.

Like-for-like Performance

%	2016	2015		2014	2013	2012	2011	2010	2009	2008	2007
Bar	**+3.3**	+1.2		+2.7	+3.8	+2.8	+1.7	-0.8	+2.5	-4.3	+3.3
Food	**+3.5**	+7.3		+12.0	+10.9	+4.8	+4.2	+0.1	-0.4	+7.9	+12.6
Machines	**-2.2**	-2.8		-3.1	+0.4	-2.8	-3.9	+12.1	-7.5	-5.8	+2.7
Hotels	**+9.7**	+24.2		+6.3	-	-	-	-	-	-	-
LFL sales	**+3.4**	+3.3		+5.5	+5.8	+3.2	+2.1	+0.1	+1.2	-1.1	+5.6
LFL Pub profit*	**-0.3**	-1.1		+2.0	+4.4	-2.2	-1.2	-2.0	-1.7	-6.6	+7.0

As you can see from the screenshot above, only in 2008 has the company failed to increase LFL sales during the last decade. What you can see is the growing influence of food and latterly hotels to the LFL performance although drink has performed well recently.

The change in sales mix towards food over the years away from drink has had a dampening effect on margins (LFL pub profit growth has lagged LFL sales growth) as food has a lower gross margin than drink. That said, most pubs these days use food as a way of driving drinks sales as they increasingly complement each other.

However, profitability has been a bit of an issue in recent years as LFL pub profits fell in both 2015 and 2016. Things look to be improving in 2017 though.

Current trading has continued to be good with LFL sales accelerating during the 13 weeks to 23 April by 4%. This is a very good performance which has also been helped by the slimming down of the pub estate and the disposal of 36 under-performing pubs.

Profit margins are on the up as well and are 150 basis points higher than a year ago at 7.8% (6.3%). Wetherspoon gave its staff a significant pay rise last year before the new living wage levels were announced and so hasn't taken a hit from this significant cost this year - so far.

However, the company has warned that costs will increase during the second half of 2017:

> *"As previously reported, the company expects significantly higher costs in the second half of the financial year, mainly for business rates, utility taxes, excise duty and labour. In view of these costs and stronger sales comparisons, the company remains cautious about the second half of the year.*
>
> *"Nevertheless, as a result of better-than-expected year-to-date sales, we currently anticipate a slightly improved trading outcome for the current financial year, compared with our expectations at the last update.*
>
> *"As a result of these higher costs the company anticipates it will require like-for-like sales of about 3 to 4% in our next financial year to maintain profits at current levels."*

This has led analysts to upgrade 2017 profit forecasts but to probably trim 2018's. 3-4% LFL sales growth on the back of strong sales in 2017 will be a challenge in my view. This is what broker Peel Hunt had to say following the trading update (This is taken from the Dow Jones news feed in SharePad).

News for Wetherspoon (J D) PLC

Headline DJ **Peel Hunt Lifts JD Wetherspoon Target Price, Upgrades FY17 Profit -- Market Talk**

Date/Time **Wed May 03 2017** 10:46:06

0946 GMT - Peel Hunt lifts JD Wetherspoon PLC target price to 1,000p from 925p. The broker also upgrades fiscal 2017's GBP87.4M pretax profit forecast by 5% after the pubs operator reported third quarter sales growth and said it expects a slight improvement to its FY17 trading. However, "we do not envisage much earnings growth in 2018 and 2019 due to further cost inflation, disposal benefits slowing, and the cost of debt rising to 5% from 4% in 2019," Peel Hunt says. Wetherspoon shares currently trade 3.6% higher at 1,046p. (razak.baba@wsj.com; Twitter: @Raztweet)

Taking Peel Hunt's forecast of £87.4m pre-tax profit for 2017 and taking the company's guidance of 26.8% for the tax rate gives an estimated post tax profit of £64m for 2017. The current market capitalisation is £1150m at 1038p per share which gives a forecast PE of 18 times. That's quite high given the expectation on flat earnings in 2018 and 2019 and certainly no bargain in my view despite being a fan of the Wetherspoon business model.

As much as I like the way Wetherspoon runs itself, the returns it generates from its assets are not stellar. The cash return on cash invested (EBITDA less tax as a percentage of gross capital employed) was less than 10% in 2016. The company helpfully shows investors how this figure is calculated in its investor presentations.

wetherspoon

Appendix D1

ROC/CROCCE/ROE

		FY 2016 £000	FY 2015 £000
Shareholders equity per accounts		**207,448**	222,893
Deferred tax balances		**63,015**	69,777
Interest rate swaps valuations		**63,477**	39,973
Impairment balances		**43,054**	49,769
Net book value of revalued assets		**(6,550)**	(7,244)
Adjusted shareholders equity	**(a)**	**370,444**	375,168
Debt		**650,760**	601,108
Capital employed	**(b)**	**1,021,204**	976,276
Accumulated depreciation (excluding impairments)	**(c)**	**755,698**	712,065
Cash capital employed	**(d)**	**1,776,902**	1,688,341

Appendix D2

ROC/CROCCE/ROE

wetherspoon

		FY 2016 £000	FY 2015 £000
EBITDA (cash return)	**(e)**	**187,274**	178,482
Depreciation and amortisation	**(f)**	**(72,212)**	(66,668)
EBIT	**(g)**	**115,062**	111,814
Interest		**(34,452)**	(34,016)
Profit before tax		**80,610**	77,798
Current tax	**(h)**	**(18,347)**	(21,544)
Profit after cash tax	**(i)**	**62,263**	56,254
Deferred tax credit/(charge) (excluding exceptional items)		**(5,342)**	1,201
Profit after tax		**56,921**	57,455
Return on capital employed [(g+h)/average b)*		**9.7%**	9.5%
Cash return on cash capital employed [(e+h)/average d)*		**9.7%**	9.6%
P&L return on shareholders equity [i/average a]*		**16.7%**	15.2%
Cash Return on Investment [(i-f)/(average a+c)]		**12.2%**	11.7%

There is possibly a read across for the rest of the pub sector as well from Wetherspoon's trading update. Higher utility costs, business rates and wage costs are likely to be an issue for the whole sector. Unless pub companies can generate significant LFL sales to compensate then underlying profitability is unlikely to grow and may fall. Growth will have to come from cost cutting, new openings and disposal of poorly performing pubs.

Share Discussion: J Sainsbury (LSE:SBRY)

The problems facing the UK's big supermarket chains are well known. Intense competition has put downwards pressure on profits and profit margins. This has been compounded by food price deflation - which has reduced selling prices - and rising operating costs.

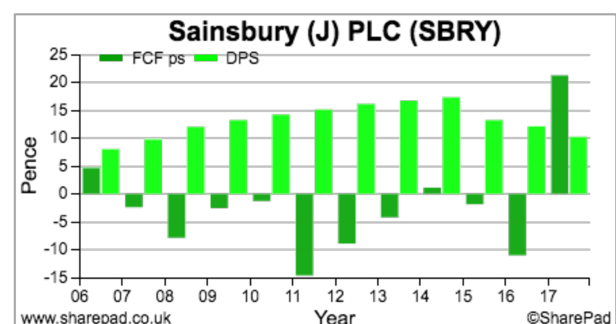
Supermarkets do not seem to have found a way of making significant amounts of money from selling groceries online whilst convenience stores are taking sales away from larger stores and making it harder to absorb the overhead costs.

The likes of Sainsbury, Tesco and Morrisons have tightened their belts and slashed investment (capex) to free up cash flow and cut prices. By the looks of Sainsbury's 2016/17 results announced this week it is not doing it much good.

Sainsbury's online groceries and convenience stores are generating steady growth but the retail profitability is poor. Profits fell by £9m to £626m in 2016 which doesn't look too bad at first glance.

However, this was after £130m of cost savings and £77m of profits coming from Argos which it bought in September. Without these two factors, retail profits would have collapsed.

Given this backdrop and the increased number of shares diluting earnings, a decline in the dividend of 15.7% is not really surprising. One good thing is that it seems that Sainsbury's is at last paying a dividend out of its free cash flow having failed to do so for the last decade. Free cash flow per share was 21.2p last year against a total dividend per share of 10.2p.



One of the key questions for investors is will dividends start increasing again?

A large part of the answer to this question depends on how well Argos does. I like Argos from a customer perspective and think that it has potential to do well for Sainsbury's. The initial performance of Argos seems to be encouraging. There are currently 59 Argos Digital Stores with plans to increase this to 250 by 2019. Sainsbury's is saying that the sales uplifts from Argos stores in supermarkets is running between 20-30% which is impressive. There is also a 2% uplift in grocery sales where there is an Argos in store.

Argos and Sainsbury's also seem well placed to exploit the continued growth in click and collect and become a major force in non-food retail. The company has a strong platform in homewares and clothing too where recent sales growth has been good.

Yet it is the grocery business that will continue to weigh heavily on the company. Sainsbury's profitability seems to be heavily dependent on cost savings. It is on track to take out £500m of cost in the three years to March 2018 and will then attempt to take out another £500m in the following three years. There is also a £160m savings target from integrating Argos.

The potential problem for Sainsbury's and its shareholders is how much of the cost savings will it be able to hang on to. For example, will it have to reinvest a significant amount of them into cutting prices in order to stay competitive with its rivals?

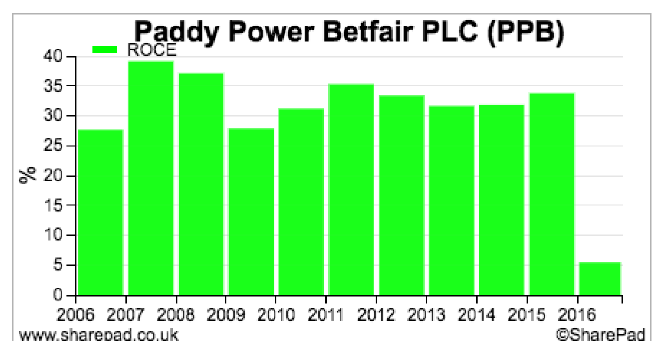
City analysts don't seem to be too optimistic about the company's ability to grow its earnings over the next couple of years. Given that backdrop and a forecast PE of 13 my guess is that the shares might struggle to make much progress from current levels for a while.

Share Discussion: Paddy Power Betfair (LSE:PPB)

The gambling industry has seen a wave of consolidation over the last couple of years. These have mainly been done for defensive reasons to counter the twin threats of increased online competition and the increased threat of regulation.

Paddy Power has handsomely rewarded its long-term shareholders but since announcing its merger with Betfair at the end of 2015 its share price has struggled to make much progress.

Prior to the merger with Betfair, Paddy Power had been able to grow strongly whilst generating excellent returns on capital (ROCE). Now that the two companies have got together the capital invested in the business has increased significantly and ROCE has fallen sharply. The challenge facing the company is to get those returns up to decent levels again.



This week's first quarter trading statement shows that 2017 has got off to a very good start for the company. Following a bad Cheltenham festival in 2016 when results went against bookmakers, 2017's festival was much kinder to them; 19 out of 28 races were profitable compared with just 11 in 2016.

With good progress on merger cost savings (headcount reductions and merging the online technology platform), trading profits more than doubled in Q1.

The company's online sales grew by 15% whilst like-for-like revenue growth from its betting shops was even better at 16%. One very powerful theme of the results was the significant operating leverage seen. Total revenue growth of 23% translated into a 114% increase in operating profits as operating costs only increased by 5%.

Of course, operating leverage can work both ways, especially in betting shops where there are lots more fixed overheads. Also, it is important to note that profits growth is very much a function of a comparably weak 2016.

That said, the company looks to be in rude health with net cash of £133m (excluding customer balances).

Investing in betting companies is not for everyone. Even if it is, there can be no guarantee that the stellar returns that have been earned by some companies in the past can be repeated in the future. Increased regulation is a serious threat to profitability, especially for betting shops with in store gambling terminals which the government is likely to crack down on - perhaps by limiting the size of stakes customers can make. There is also talk of a crackdown on TV advertising by betting companies.

Talking of which, if you are a regular watcher of sport on TV then you must have noticed the huge number of adverts by different betting companies that you are bombarded with. This is a very clear sign of the amount of competition and promotional activity that exists within the sector which is not an ideal environment for growing profits.

None-the-less, analysts seem to be quite bullish on the outlook for Paddy Power Betfair's profits over the next couple of years. However, the shares trade on 20 times forecast earnings which looks high enough given the uncertainties surrounding the betting industry.

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