Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

26th May 2017

Market overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7517.71	▲1.09	▲3.33	▲20	7522.03	5923.53	16/5/17	14/6/16
FTSE 250	19967.6	▲1.4	▲1.97	▲15.9	19967.6	14967.9	25/5/17	27/6/16
FTSE SmallCap	5644.88	▲1.28	▲2.46	▲23.5	5647.41	4272.07	24/5/17	27/6/16
FTSE AIM 100	4928.09	▲2.3	▲4.64	▲42.9	4928.09	3188.77	25/5/17	27/6/16
S&P 500	2416.47	▲2.15	▲1.17	▲15.6	2416.47	2000.54	25/5/17	27/6/16
UK Treasury 10 Year Par Yield	1.08	0	▼-0.917	▼-29.4	1.54	0.61	26/1/17	12/8/16
Brent Oil Spot $	$51.975	▼-0.972	▼-0.0192	▲4.4	$56.965	$41.965	29/12/16	2/8/16
Gold Spot $ per oz	$1256.31	▲0.619	▼-0.586	▲2.55	$1366.48	$1128.22	6/7/16	15/12/16
GBP/USD - US Dollar per British Pound	1.29605	▲0.044	▲0.997	▼-11.8	1.47895	1.20401	22/6/16	16/1/17
GBP/EUR - Euros per British Pound	1.1553	▼-0.926	▼-1.62	▼-12.3	1.3174	1.1066	25/5/16	13/10/16

Top 10 FTSE All-Share winners

No.	TIDM	Name	%chg 1w
1	HSS	HSS Hire Group PLC	▲21.7
2	WIZZ	Wizz Air Holding PLC	▲16.6
3	SHI	SIG PLC	▲15.7
4	ICP	Intermediate Capital Group PLC	▲14.9
5	IMG	Imagination Technologies Grou...	▲14.4
6	LSL	LSL Property Services PLC	▲13.8
7	EZJ	easyJet PLC	▲12.2
8	PDG	Pendragon PLC	▲11.4
9	FXPO	Ferrexpo PLC	▲9.64
10	JE.	Just Eat PLC	▲9.12

Top 10 FTSE All-Share losers

No.	TIDM	Name	%chg 1w
1	ACA	Acacia Mining PLC	▼-38.4
2	PFC	Petrofac Ltd	▼-34.9
3	LMI	Lonmin PLC	▼-14.4
4	KGF	Kingfisher PLC	▼-10
5	RWI	Renewi PLC	▼-9.79
6	TPT	Topps Tiles PLC	▼-9.31
7	RNO	Renold PLC	▼-8.5
8	AMFW	Amec Foster Wheeler PLC	▼-8.45
9	WG.	Wood Group (John) PLC	▼-7.26
10	MDC	Mediclinic International PLC	▼-7.18

Share Discussion: Severn Trent (LSE:SVT)

Water companies were in the news last week. The Labour party election manifesto said that it wanted to nationalise the water industry and use the money currently paying dividends to shareholders to reduce customer bills. This did not scare investors due to the unlikely outcome of a Labour election victory.

Of far more interest to investors is how well water companies perform against the targets set for them by industry regulators.

Water companies have been regulated since their privatisation in 1989. Every five years, the regulator sets price limits for each company which tells them how much they can charge their customers. In return for cash from customers, the water companies are given spending budgets to maintain and upgrade the water and sewer networks. They are also given specific targets on performance measures such as leakage, sewer flooding and supply interruptions.

The regulator also takes into account how much it will cost water companies to finance their businesses. It looks at the interest rates they will have to pay on their borrowings and the dividends they will have to pay to keep shareholders happy. This is known in financial jargon terms as the cost of capital.

If the regulator does its job well then the water companies will be able to make a fair return on their assets (reservoirs, pipes, and sewage systems - known as the Regulatory Capital Value or RCV). If the water company exactly matches the regulator's spending limits its return on its RCV will equal its cost of capital.

The RCV and the companies' spending limits are linked to RPI inflation. This means that a decent water business should see its profits and cash flows grow in line with inflation. Any expansion of the water network grows the value of the RCV and allows higher profits.

A water company can also grow its profits by spending less than the regulator allows to deliver its service quality outputs (and get incentive bonuses for delivering them) and by financing its business cheaper than the regulator's estimates.

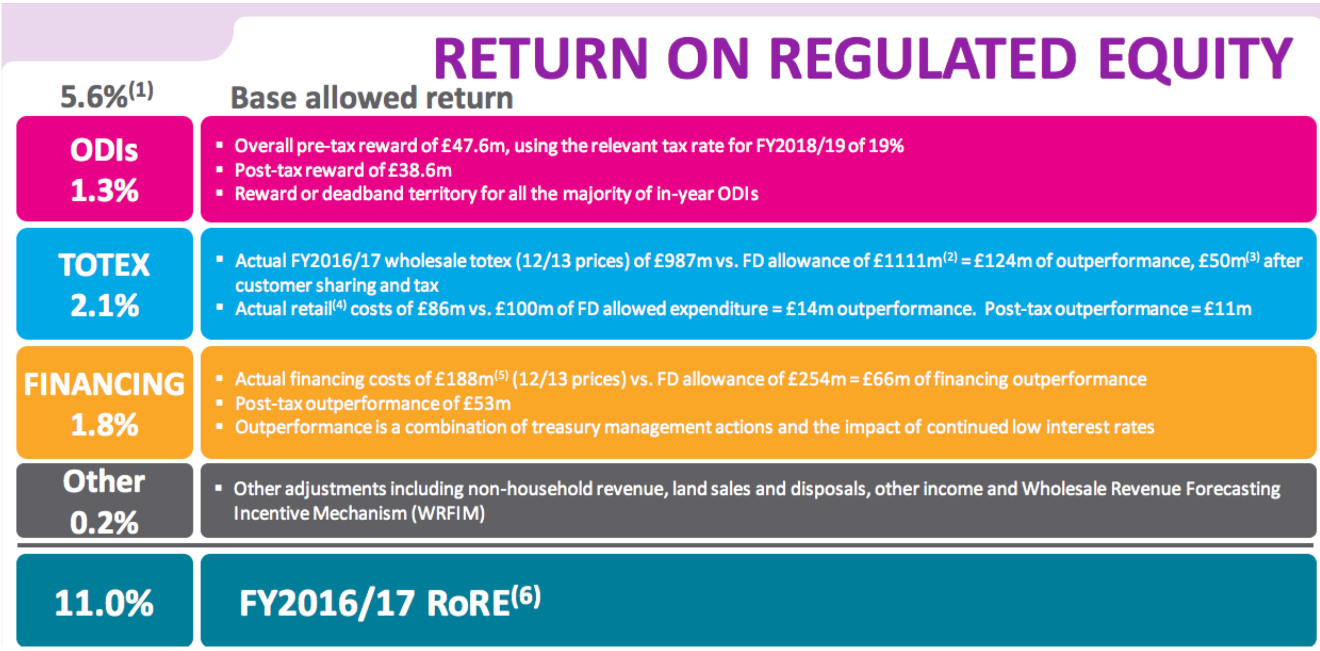
This means that a good water company can be an attractive proposition for investors. They can effectively lock into an inflation-proofed dividend stream for 5 years (and hopefully longer) at much higher yields than government index-linked bonds. This has made companies like Severn Trent a popular investment in recent years but can the good times last?

Based on the evidence of its annual results released this week it seems that they can. The company delivered a very solid set of results with trading profits up by 4.3%. However, it was its performance against its regulatory targets which will have pleased its shareholders.

Severn Trent is doing a good job for its customers by improving its service quality whilst charging them the lowest bills in England.

It is also doing a good job for its shareholders. It is being more efficient on its spending than the regulator assumed at its last price review in 2015 - and therefore making more money - and continues to borrow at lower interest rates to reduce its cost of capital.

The screenshot below, taken from the company's results presentation, shows its performance against its regulatory targets and how this translates into returns for shareholders.



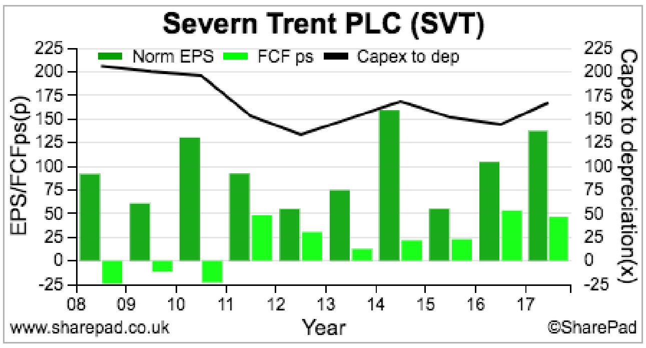
Let me explain how this works.

- The base return of 5.6% is the equivalent to a water company's return on capital employed (ROCE). It is its trading profits expressed as a percentage of its RCV. The returns are real returns - they are adjusted for inflation.
- ODIs or outcome delivery incentives. These are the rewards or penalties a water company receives or pays depending on whether it meets certain performance criteria on measures such as customer complaints, leakage targets and supply interruptions. The company has done well in the last year, pocketing £47.6m of rewards.
- Totex - this is the operating expenditure (opex) and capital expenditure (capex) added together. The company can boost its profits and returns to shareholders by spending less (being more efficient) in delivering its regulatory targets. Severn Trent has spent £124m less than its regulatory allowance.
- Financing. The company has been very good at borrowing money at lower interest rates than the regulator thought it could. Severn Trent's effective interest rate on its borrowings has fallen from 5.4% a couple of years ago to just 4.4% now. Its interest bill is £66m less than its regulatory allowance.

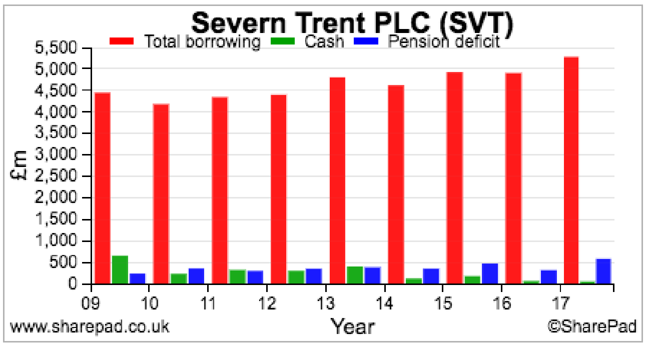
When all these effects are added together and a gearing ratio of 61.6% (net debt to RCV) is taken into account, Severn Trent is earning a return on regulatory equity (RORE) of 11%.

For a regulated business, that's pretty good. As far as shareholders are concerned, this 11% return essentially gets paid to them in the form of dividends over the 5 year regulatory period from 2015-2020.

This is an important point. Water companies are very capital-intensive and generally do not produce sufficient free cash flows to cover their dividend payments.

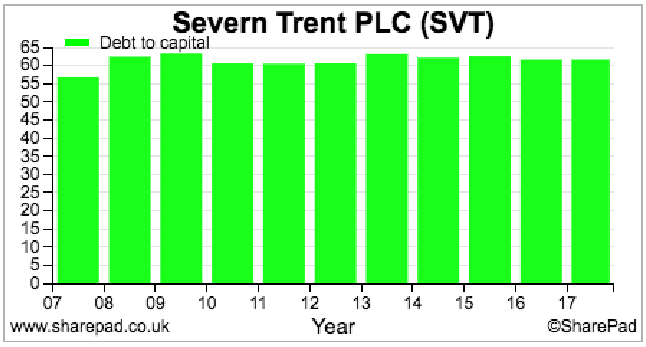


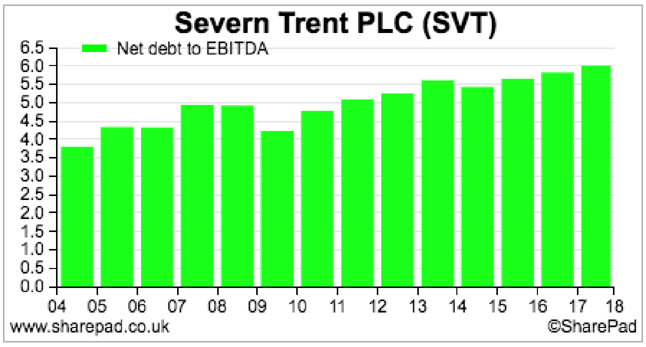
This is because they are spending money to enhance the water and sewerage networks. This capex is financed by borrowing. The dividend is covered by the RORE described above. Severn Trent is not borrowing to pay its dividend in my view. Back in September 2015, my article **How to analyse water companies** took a detailed look at this issue and came to this conclusion.



Because water companies are capital intensive but have very stable and predictable income stream they can finance themselves with lots of debt. High debts are generally something to worry about but most water companies are careful not to overload their balance sheets with debt.

Severn Trent's debt levels have been creeping up very slightly. There is also a significant pension fund deficit that needs to be watched.

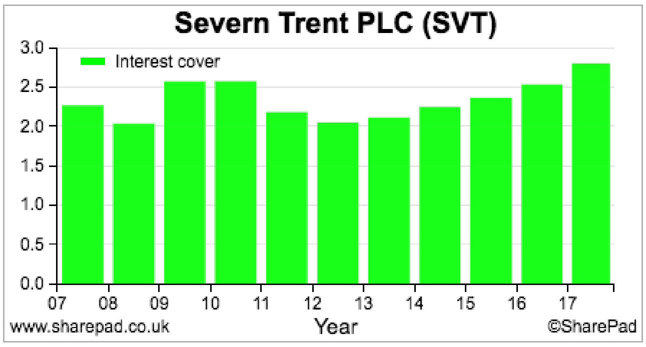




What we can see by studying Severn Trent's debt history in SharePad is that, on measures such as Debt to Capital Employed and Net debt to EBITDA, debt levels have been quite stable in recent years.

Interest cover has actually improved as the company's effective interest rate has come down whilst trading profits have gone up.

From an operating and financial perspective, Severn Trent looks like it is doing well but are its shares cheap or expensive?



They look relatively expensive compared to the rest of the quoted utility sector. However, the most bullish outcome from Severn Trent's results this week was that it upgraded its dividend growth forecasts to at least RPI + 4% out to 2020. This is not yet reflected in consensus analyst forecasts. Based on a forecast committed dividend per share for 2017/18 of 86.55p, the shares have a forecast yield of 3.4%.

TIDM	Name	Price	fc Yield
CNA	Centrica PLC	205.95p	5.8
NG.	National Grid PLC	£10.7475	4.6
PNN	Pennon Group PLC	909.25p	4.0
SVT	Severn Trent PLC	£25.35	3.3
SSE	SSE PLC	£15.35	6.1
TEP	Telecom plus PLC	£12.99	3.7
UU.	United Utilities Group PLC	£10.515	3.7

Valuing Severn Trent's shares is ideally suited to using a dividend valuation model. The good news is that SharePad has one that you can use in the **Investor tools** section of the software.

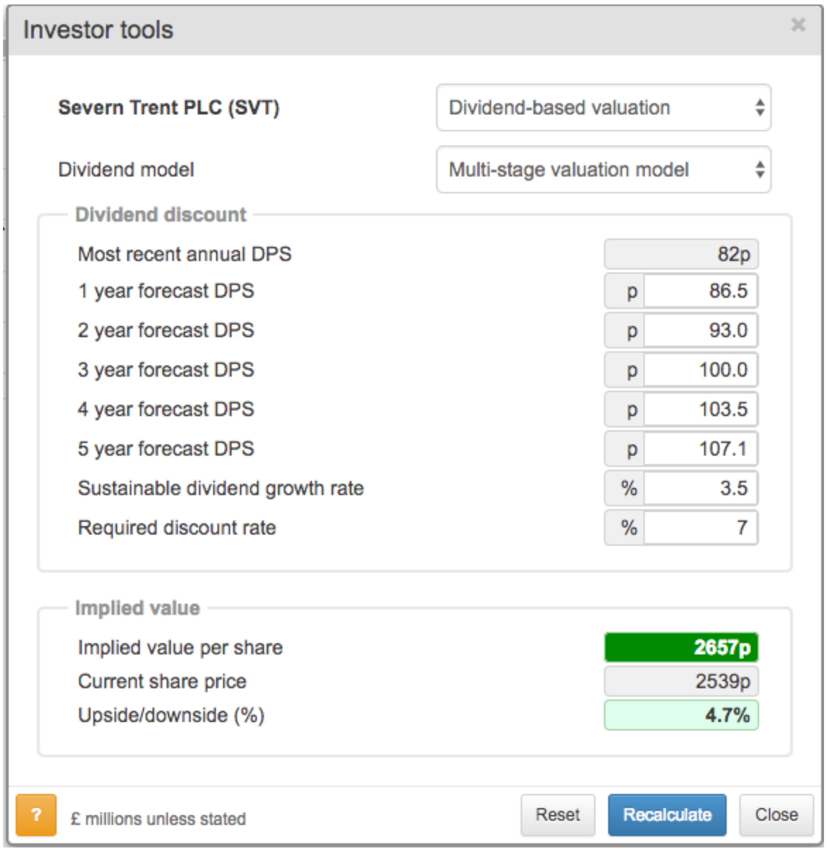
Let's see how much the company's shares might be worth if we factor in its revised dividend growth forecasts.

I am using a multi-stage valuation model and take 86.55p as my first year forecast. With RPI inflation currently at 3.5% I add 4% to that to get a 7.5% growth rate for the following two years. This takes us to 2020 and the end of the current price setting period.

It's important to remember that if water companies do better than the regulatory targets in the current period, there's a very good chance that these benefits will have to be shared with customers and reflected in their bills in the next one. This then makes it harder for Severn Trent to squeeze out excess profits going forward. I have reflected this assumption by assuming dividends only grow at the rate of RPI inflation in years 4 and 5 of my forecast and thereafter.

Using a 7% discount rate to reflect the relatively low risk of water company shares this gives a value of 2657p per share. However, I need to adjust my valuation for the fact that the shares have the right to receive the final dividend per share for 2016/17 of 48.9p which trades ex-dividend on 15th June 2017. Adding this gives a valuation for Severn Trent shares of 2706p implying around 6.5% upside compared with the current share price.

The valuation will be sensitive to changes in the rate of inflation. If RPI inflation falls back to lower levels then the dividend growth rate and the valuation of the shares will fall as well. To me, it looks as if Severn Trent shares are fairly valued at the moment.


Investor tools

Severn Trent PLC (SVT) — Dividend-based valuation

Dividend model — Multi-stage valuation model

Dividend discount

Most recent annual DPS		82p
1 year forecast DPS	p	86.5
2 year forecast DPS	p	93.0
3 year forecast DPS	p	100.0
4 year forecast DPS	p	103.5
5 year forecast DPS	p	107.1
Sustainable dividend growth rate	%	3.5
Required discount rate	%	7

Implied value

Implied value per share	2657p
Current share price	2539p
Upside/downside (%)	4.7%

? £ millions unless stated — Reset — Recalculate — Close

Share Discussion: Cranswick (LSE:CWK)

Cranswick is a supplier of premium meat products with a focus on pork and poultry. It is the third largest pig producer in the UK and accounts for 5% of the market. 90% of its pigs are bred outdoors which gives it a competitive edge when it comes to the provenance and quality of its products.

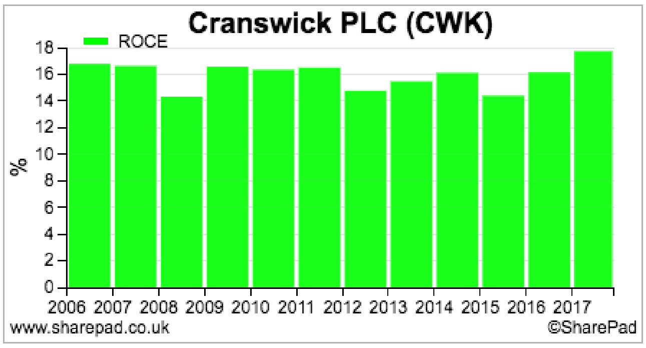
The company is one of the biggest food producers in Britain and has invested extensively in modern production facilities and logistics so that it controls the supply chain. It sells to supermarkets, retailers and foodservice companies. If you've eaten premium sausages from Tesco and Sainsbury's in recent years, they were made by Cranswick.

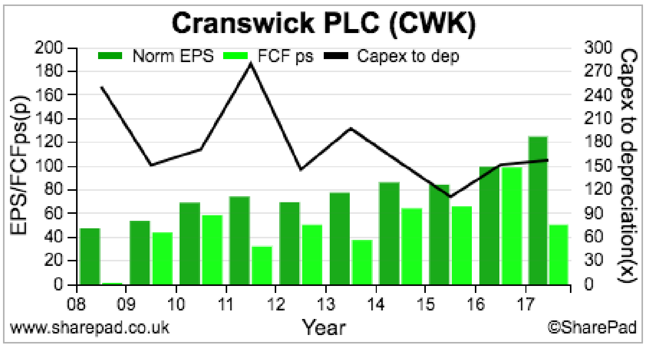
Most of Cranswick's sales are made in the UK but it does have a growing export business to places such as China. The breakdown of its business by business line and some of the products it sells are shown in the table on the right.

Business	% of Revenue	Products
Fresh Pork	32	Pork meat
Convenience	38	Cooked meats
Gourmet Products	19	Sausages, bacon, pastries
Poultry	11	Fresh & cooked poultry

This business ticks a lot of boxes for me. In fact, I have owned the shares in the past but sold out a few months ago (which in hindsight was a big mistake) for a couple of reasons I will touch on shortly.

One of the reasons I like this business is that it has a very consistent record in generating decent returns on capital employed (ROCE). The last three years have seen a nice tick up in ROCE as well.

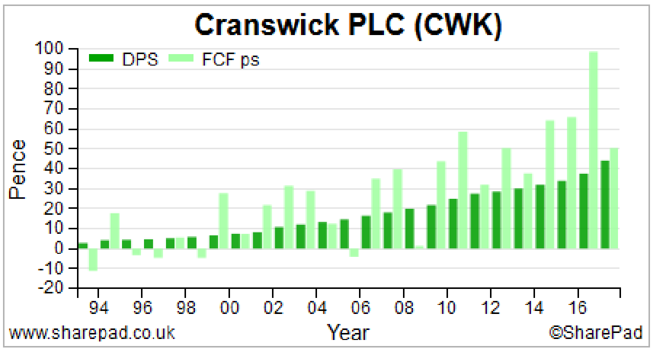




Underlying free cash flow generation hasn't been too bad either, despite consistently high rates of investment in production facilities.

2017 saw a significant £18.6m cash outflow from working capital due to the growth in the business compared with a £9m inflow in 2016. I don't think this is anything to worry about as stock and debtor levels as a percentage of sales have been well controlled.

The other good hallmark of quality is Cranswick's dividend track record. It has proven to be one of the best dividend payers on the UK stock market having grown its dividend for the last 24 years and usually paid them from free cash flow.

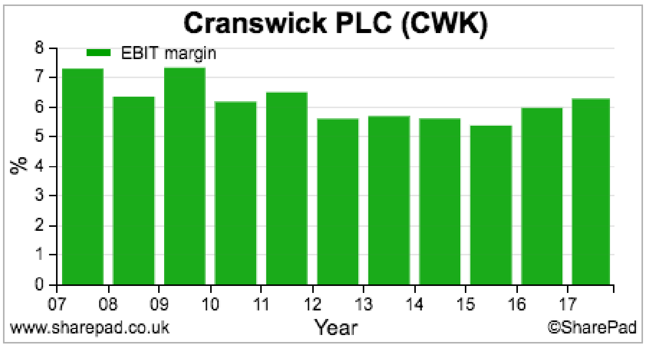


Cranswick's full year results released this week show that it had a great year. Sales were up by 22.5% driven by acquisitions but were still up by 12.7% on a like-for-like basis which is still very impressive. EPS was up by 17.6% and the final dividend was increased by 19.7%.

All four businesses performed well. The Fresh Pork business saw sales grow by 6.7% with exports up 49% (albeit still a small portion of overall sales) due to strong demand from China. Sales volumes were muted as most of the sales growth came from a significant increase in the UK pig price where average prices increased by 8% during the year. Convenience sales increases by over 20%, Gourmet products by 19% whilst Poultry like-for-like sales increased by nearly 18%.

The company is gaining market share and seems to have prioritised sales volume growth at the expense of a slight reduction in operating (EBIT) margins which fell slightly on a company adjusted basis (up slightly on a normalised basis).

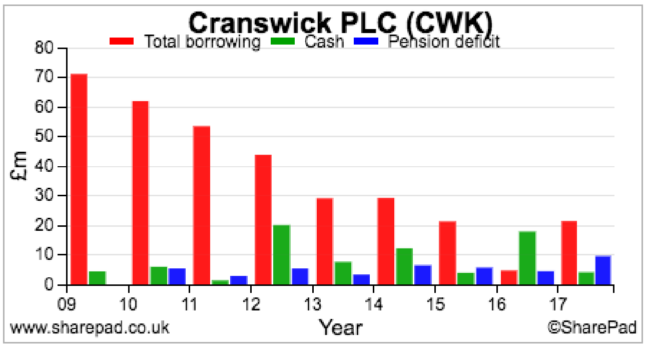
The company's operating margin was one of the main reasons I sold my shares in Cranswick a few months ago.



Cranswick's margins have always been on the lowish side although this has not stopped it producing the high ROCE that I look for in a business. It's just that in recent times I have been focusing my investing strategy on companies with high profit margins (more than 10%).

I have been focusing more on margins because I believe that higher profit margin businesses tend to make safer investments (as long as they are not temporary or from selling overpriced products or services). This is because a business with a high profit margin can withstand a temporary profit setback a lot better than one with a lower margin.

What slightly worries me about Cranswick is that it is selling high quality products to food retail and foodservice companies which have very low margins themselves and in some cases, significant buying power. If business conditions get tougher then perhaps they will look to take a bit of Cranswick's profit margin to protect their own. Or maybe I am worrying too much?



Apart from margins, there's a lot to like about Cranswick as I've already mentioned. Its financial position is good too with very little debt and a small but manageable pension fund deficit.

From a business perspective, I like the move into poultry with the purchase of Crown Chicken. Health trends are seeing an increasing shift away from red meats to poultry and this recent acquisition should help deliver some decent growth in my view.

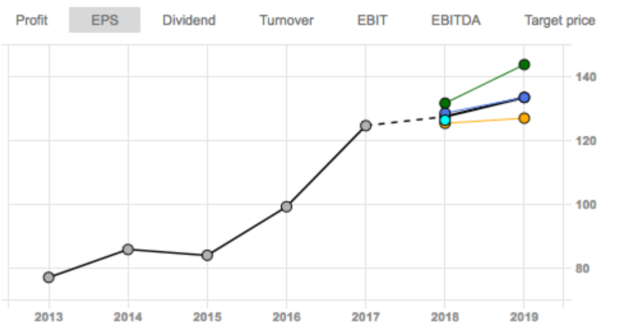
Cranswick PLC (CWK)

Key	Name	Forecast	Confirmed	Opinion	Target price
	Davy Stockbrokers	3/2/17	23/5/17		
	Investec Securities	15/2/17	10/4/17	Buy	25.65
	N+1 Singer	22/5/17	22/5/17		
	Numis Securities Ltd	2/12/16	22/5/17	Hold	23.11
	Peel Hunt LLP	26/1/17	18/5/17	Hold	20.50
	Consensus	23/5/17		Buy (5) ❶	23.09

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

← Prev Forecasts for year 2018 Next →

Key	Name	Profit	EPS	Dividend	Turnover	EBIT	EBITDA
	Davy Stockbrokers		128.8	46.3	1302.4	79.5	105.0
	Investec Securities	78.0	125.6	44.0	1318.3		105.6
	N+1 Singer						
	Numis Securities L…	83.9	131.9	47.5	1376.3	84.0	114.0
	Peel Hunt LLP	81.0	126.6	42.0	1354.3		108.9
	Consensus	81.0	127.7	45.2	1337.0	81.4	106.5



City analysts are generally upbeat about the outlook for profits growth with high single digit EPS growth expected over the next couple of years.

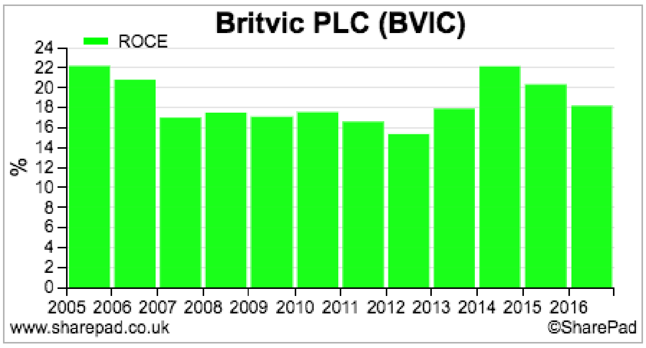
I think Cranswick is a high-quality business but at £30 per share it trades on a very full valuation of 23.5 times forecast EPS whilst only offering a dividend yield of 1.5%. The scope for a re-rating from here is possible but I wouldn't bank on it.

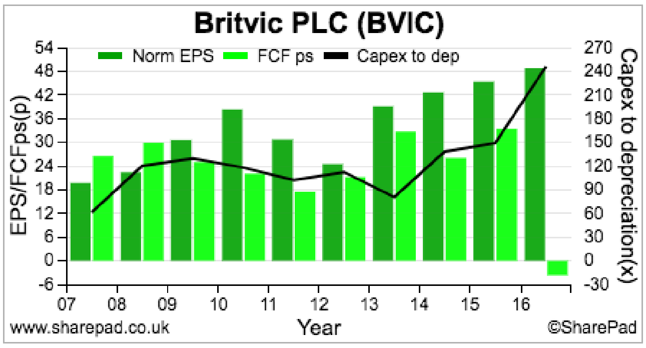
Share Discussion: Britvic (LSE:BVIC)

In November last year I wrote that perhaps Britvic shares were cheap (click **here** to read my stockwatch article on Britvic). The shares were trading at a three year low on the back of concerns about competition in the UK, the threat of a sugar tax and industry cost pressures. Back then, its current profits explained around 90% of its share price. The market wasn't pricing in much future growth.

Since then, soft drinks companies in general have been on a storming run as some of the concerns have waned. Do Britvic shares have further to run?

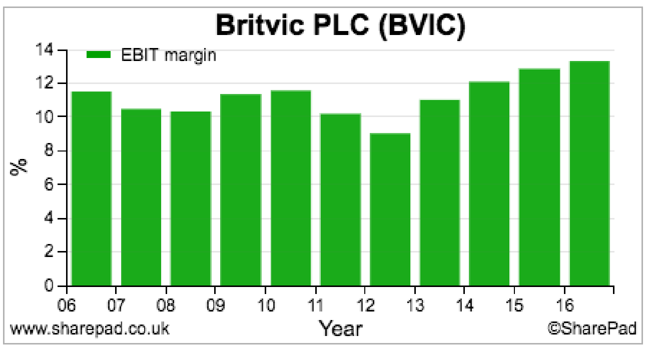
Like Cranswick above, Britivic has many hallmarks of a quality company backed by a portfolio of leading soft drinks brands such as Pepsi, 7UP, Robinsons and Fruit Shoot in the UK and leading positions in French and Irish markets. ROCE has been consistently good.

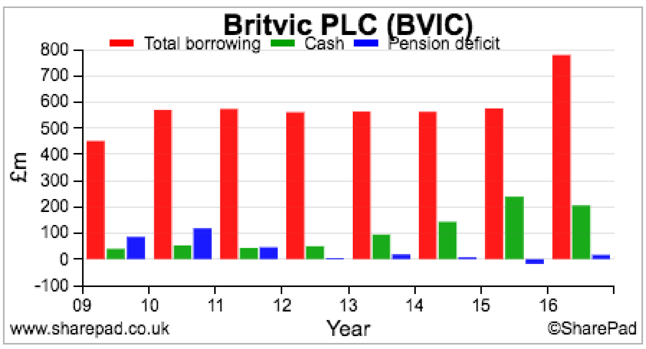




Conversion of profits into free cash flow hasn't been too bad. The company is investing heavily in new assets at the moment which has put a drain on free cash flow.

Profit margins have been quite high and resilient too.





Debts including the pension fund (which is in surplus) are manageable.

Interim results released this week show that the company has continued to make steady progress. As you can see from the table below, profits are nudging ahead on a half year and trailing twelve month (TTM) basis.

Britvic (£m)	H1 16	H2 16	FY 16	H1 17	TTM
Revenue	678	753.3	1431.3	756.3	1509.6
EBIT	65.4	113.3	178.7	68.3	181.6
Net interest	-10.9	-9.9	-20.8	-11	-20.9
PBT	54.5	102.5	157	57.3	159.8
Taxation	-12.8	-23.5	-36.3	-12.9	-36.4
Profit after tax	41.7	79.9	121.6	44.4	124.3
Diluted EPS(p)	17.2	31.8	49	18.8	50.6
EBIT margin	9.7%	15.0%	12.5%	9.0%	12.0%
Tax rate	23.5%	22.9%	23.1%	22.5%	22.8%
Interest cover	6.0	11.4	8.6	6.2	8.7

The share price went up on the day of the results. My guess is that this is due to the possibility of upgrades to full year forecasts. TTM EPS is 50.6p. Consensus EPS according to SharePad is 48.9p. With upwards momentum in profitability in the first half of the year and an outlook statement that said the company was "confident of meeting market expectations for the full year", it wouldn't surprise me if forecasts nudged up a bit.

Looking at the screenshot from SharePad below, there has been a big improvement in cash generation. Working capital performance has been better despite the usual first half stock build ahead of the peak summer season. My guess is that capex due to the heavy investment in new plastic bottling facilities is near its peak and that debt levels are too.

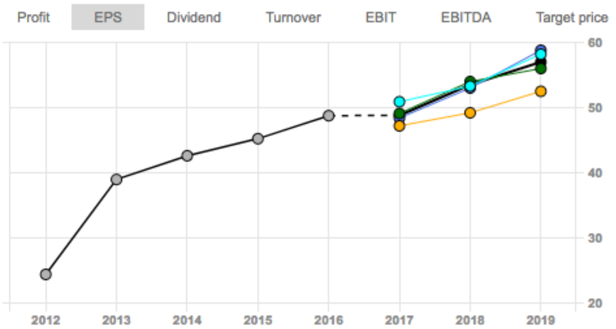
Britvic PLC (BVIC)

Key	Name	Forecast	Confirmed	Opinion	Target price
	Goodbody Stockbrokers	16/12/16	22/5/17	Buy	7.20
	Investec Securities	10/4/17	10/4/17	Buy	6.94
	Mirabaud Securities	31/1/17	31/1/17	Buy	7.20
	Numis Securities Ltd	3/3/17	2/5/17	Add	7.06
	SG Securities	4/1/17	23/5/17	Buy	6.80
	Consensus	5/5/17		Buy (5)	7.04

The actual number of estimates used to calculate the consensus opinion

← Prev Forecasts for year 2017 Next →

Key	Name	Profit	EPS	Dividend	Turnover	EBIT	EBITDA
	Goodbody Stockb...		48.5	24.3	1484.3	178.0	232.8
	Investec Securities	152.1	47.3	25.0	1422.9		228.1
	Mirabaud Securities						
	Numis Securities L...	159.4	49.2	24.9	1536.0		234.8
	SG Securities		51.0	26.5	1535.5	179.1	236.6
	Consensus	155.7	48.9	25.0	1520.1	178.6	233.9



Britvic PLC (BVIC)

← Prev Next →		2016		2017
Fiscal period ending	10/4/16	2/10/16	16/4/17	16/4/17
£ millions unless stated	Q2 IFRS	Q4 IFRS	Q2 IFRS	TTM
FREE CASH FLOW				
Net cash from operations	(1.4)	132.8	44.6	178.8
Capital expenditure	(47.3)	(121.9)	(76.8)	(151.4)
Dividends from joint ventures	-	-	-	-
Free cash flow for firm (FCFf)	(48.7)	10.9	(32.2)	27.4
Dividends paid to minorities	-	-	-	-
Interest paid	(12.2)	(22.2)	(10.7)	(20.7)
Interest received	1.2	1.7	0.5	1.0
Free cash flow for equity (FCF)	(59.7)	(9.6)	(42.4)	7.7

Britvic is a very seasonal business - because people drink more soft drinks in the summer - and I would expect another decent free cash flow inflow in the second half of the year.

There are a couple of things that mildly concern me in these results. The first is the slight decline in margins. That said, the company has contained cost pressures well. The new bottling plants should also help the company become more efficient as well as helping it to sell drinks with more flexible and innovative packaging.

The second is that the core UK business profits are pretty stagnant. All the growth in gross profits is coming from overseas where there will have been some significant assistance from currency translation effects.

Britvic (£m)	H1 17	H1 16	% chg
GB Carbonates	114.2	117.7	-3.0%
GB Stills	66.9	69.7	-4.0%
France	38.1	31.5	21.0%
Ireland	27.2	21.5	26.5%
Brazil	14.4	9.1	58.2%
International	8.6	3.9	120.5%
Total Brand contribution	**269.4**	**253.4**	**6.3%**

The company has been very upfront that it has focused on value in preference to volume in the UK fizzy drinks market (carbonates) in order to protect profits. This means a decline in promotional activity which is one of the concerns that investors have had about this market. Pepsi Max has been doing well as customers switch to sugar-free drinks.

The stills market has been tougher with Robinsons fruity squash sales under pressure. The overseas businesses have done quite well. The company seems bullish about the prospects for Fruit Shoot in the USA and has been building up its distribution capacity there.

Britvic remains by far the cheapest share in the UK soft drinks sector but that doesn't mean that it shares are really cheap, particularly when considering the valuations of shares such as Fevertree and Nichols. The yield is decent but dividend growth is low at around 3%.

TIDM	Name	Close	Market Cap. (m)	fc PE	fc Yield	TTM EV/ EBITDA	EBIT yield
BVIC	Britvic PLC	703p	£1,853.10	14.4	3.6	10.2	7.8
BAG	Barr (A G) PLC	657.5p	£767.80	21.9	2.3	18.2	4.5
NICL	Nichols PLC	£17.63	£651.80	25.1	1.8	19.7	4.9
CCH	Coca-Cola HBC AG	£22.44	£8,164.90	24.4	1.8	12.7	5.2
FEVR	Fevertree Drinks PLC	£17.22	£1,984.50	67.3	0.4	55.4	1.8

In the past, Britvic has been touted as a takeover target for Pepsi (who own the Pepsi and 7UP brands and have a 5% shareholding in Britvic), whilst a tie up with AG Barr failed to get off the ground a couple of years ago. It would not be a complete surprise if Britvic was part of some consolidation in the soft drinks market in the future.