Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

9th June 2017

Market overview

By the time you read this, the general election will be over and hopefully we will know who is running the country for the next five years. Personally, I'll be glad it's all over. As far as investing is concerned, I've never been particularly convinced that the government makes much of a difference to how shares and the stock market in general perform.

Good and bad companies will continue to exist whoever runs the country. Whether the investor makes or loses money still comes down to the prices they pay for a company's shares and its ability to grow profits and pay dividends.

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7451.06	▼-1.23	▲2.06	▲18.2	7547.63	5923.53	2/6/17	14/6/16
FTSE 250	19738.7	▼-1.36	▲0.0456	▲14.9	20024.9	14967.9	26/5/17	27/6/16
FTSE SmallCap	5607.8	▼-0.752	▲0.854	▲21	5661.48	4272.07	26/5/17	27/6/16
FTSE AIM 100	4903.3	▼-1.15	▲2.43	▲39.8	4969.33	3188.77	2/6/17	27/6/16
S&P 500	2433.14	▲0.127	▲1.41	▲14.8	2439.07	2000.54	2/6/17	27/6/16
UK Treasury 10 Year Par Yield	1.01	▼-6.48	▼-12.2	▼-24.1	1.54	0.61	26/1/17	12/8/16
Brent Oil Spot $	$48.195	▼-4.32	▼-2.53	▼-8.57	$56.965	$41.965	29/12/16	2/8/16
Gold Spot $ per oz	$1284.70	▲1.58	▲4.63	▲1.56	$1366.48	$1128.22	6/7/16	15/12/16
GBP/USD - US Dollar per British Pound	1.29441	▲0.448	▲0.0216	▼-10.8	1.47895	1.20401	22/6/16	16/1/17
GBP/EUR - Euros per British Pound	1.1539	▲0.4	▼-2.56	▼-9.34	1.3055	1.1066	22/6/16	13/10/16

This week has been an interesting one on the markets. I am wondering if we have begun to see the big outperformance of smaller company shares starting to crack. We have seen some sharp sell offs in some highly valued small caps which hasn't really surprised me given the strength of some share prices in recent months.

The economic backdrop also seems to be less favourable. The May retail sales figures were very poor and will put further pressure on a sector that is already struggling with the rising costs of wages and business rates. If revenue growth is harder to come by then it would not surprise me if we see an increase in profit warnings in the weeks and months ahead.

I remain quite nervous on the valuations of some high quality businesses. To me, the ratings for many seem too high given that growth has been flattered in many cases by the fall in the value of the pound. Underlying growth excluding this effect is actually quite modest and could become more visible to investors in the second half of 2017 when the effect of the pound's devaluation could wear off.

Top 10 FTSE All-Share winners

No.	TIDM	Name	%chg 1w
1	PSDL	Phoenix Spree Deutschland Ltd	▲12.3
2	BRSN	Berendsen PLC	▲11.2
3	KNOS	Kainos Group Ltd	▲7.86
4	CMCX	CMC Markets PLC	▲6.34
5	POG	Petropavlovsk PLC	▲6.13
6	ACA	Acacia Mining PLC	▲5.43
7	VP.	Vp PLC	▲5.33
8	MPO	Macau Property Opportunities F...	▲5.31
9	WKP	Workspace Group PLC	▲5.14
10	UAI	U and I Group PLC	▲5

Top 10 FTSE All-Share losers

No.	TIDM	Name	%chg 1w
1	LMI	Lonmin PLC	▼-16.8
2	PFC	Petrofac Ltd	▼-13.1
3	ENQ	EnQuest PLC	▼-12
4	SIV	St Ives PLC	▼-9.8
5	TLW	Tullow Oil PLC	▼-9.09
6	MOSB	Moss Bros Group PLC	▼-8.04
7	LSL	LSL Property Services PLC	▼-7.11
8	ALD	Aldermore Group PLC	▼-7.7
9	HTG	Hunting PLC	▼-7.61
10	PMO	Premier Oil PLC	▼-7.37

Share Discussion: Somero Enterprises (AIM:SOM)

Somero designs, makes and sells products that are used by concrete flooring contractors. Its products are typically used in non-residential construction markets in buildings which need large, flat flooring areas such as warehouses, manufacturing plants, retail outlets and car parks.

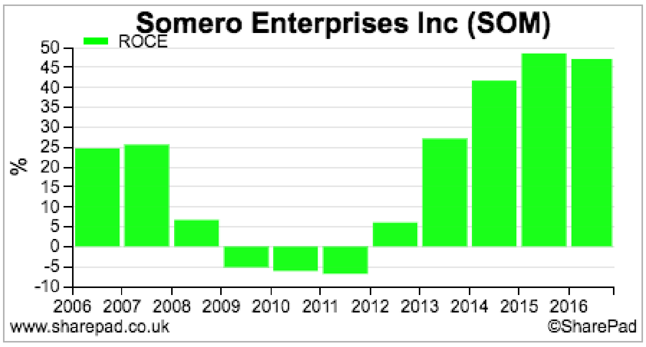
The company's core products are its laser screed machines which allows its users to produce high quality, flat concrete floors for a much lower cost and in a much faster time compared to doing the job manually. The key selling point to customers is that they can make more money by using a Somero machine.

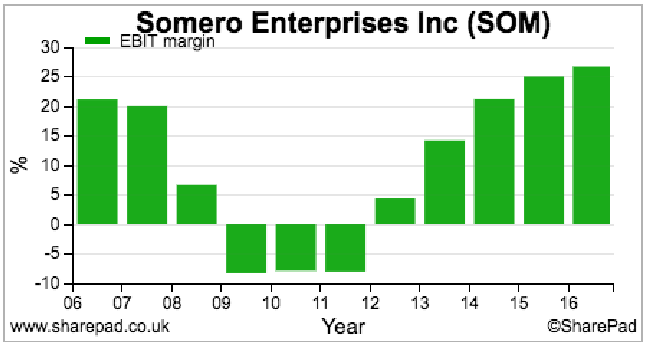
Somero competes on the basis of product quality and service. In addition to selling its products, it provides aftermarket services, education and training to its customers. This gives it a competitive edge.

From selling one product when the business began trading in 1986, it now has a portfolio of 13 products which are backed by 63 patents to protect them from competition.

Somero's share price has seen a stellar rise over the last 18 months, but this week's trading statement has received a thumbs down from investors. More on this shortly, but before I discuss it, let's take a look at how the company stacks up on some key performance indicators.

At the moment Somero is producing very impressive returns on capital employed (ROCE) of over 45%. You can see how ROCE has improved significantly since 2012. But you can also see that the company was loss making between 2009 and 2011. This is telling us that Somero is a very cyclical business which is not really surprising given that non-residential construction is a highly cyclical activity.

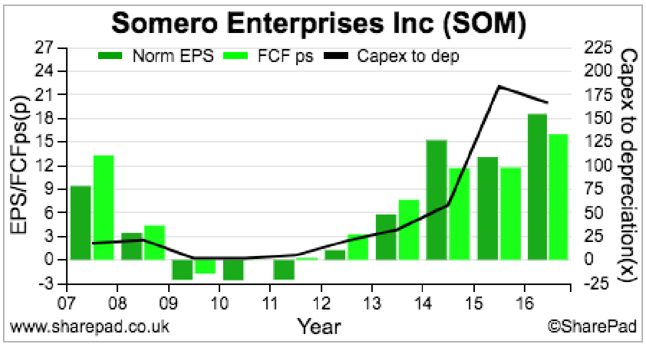


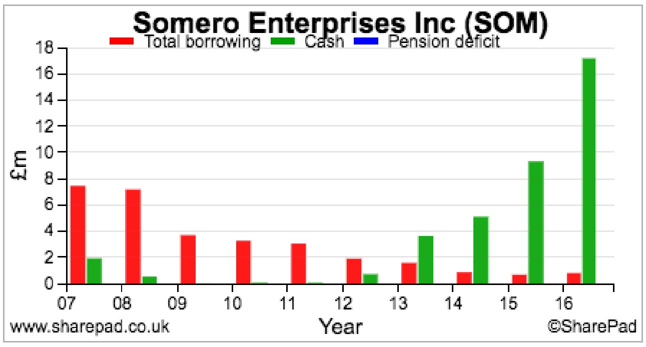


The current ROCE is also significantly higher that the previous cyclical peak seen in 2007. Predicting the future is difficult but if it bears some resemblance to what has happened in the past then Somero's profitability could be very close to another peak. This gives grounds for thinking that perhaps the easy money has been made from owning Somero shares.

This view is backed up by an examination of the company's operating profit (EBIT) margins. The pattern is very similar to ROCE. The margins show strong evidence of cyclicality and as with ROCE are now higher than the previous cyclical peak in 2006.

The conversion of profits into free cash flow has shown similar trends. The company was loss making between 2009 and 2011 with a strong recovery since then. At the moment free cash conversion is pretty good, especially as investment in the business is quite high with capex significantly more than depreciation.





The company's financial position is in much better shape than at the peak of the last economic cycle. Borrowings are currently minimal, whilst the company has been building up a significant cash balance. This should reassure investors as the company is much better placed to withstand a downturn in trading than it was a decade ago.

We can see that Somero is currently performing well with high ROCE, high margins and a strong financial position. However, whilst that is all well and good, the key driver of a company's share price is profits and growth and this is what investors have started to worry about this week. Monday's trading update saw the shares fall by 7.5%.

To put the trading update into perspective, I have included a screenshot of Somero's geographical revenue breakdown from its latest annual report. You can see that the vast majority of its revenue and revenue growth in 2016 came from North America and Europe.

	US$ in millions	
Regional sales	2016	2015
North America	**56.6**	49.2
Europe	**8.0**	5.7
China	**6.4**	6.1
Middle East	**2.9**	2.7
Australia	**2.3**	1.0
Latin America	**1.7**	2.0
Scandinavia	**0.5**	0.5
Southeast Asia	**0.4**	1.3
Korea	**0.3**	1.0
Russia	**0.2**	0.1
India	**0.1**	0.6
Total	**79.4**	70.2

The trading statement said that the performance of the North American business during the first half of 2017 has been flat. This has been blamed on poor weather conditions with the company citing a significant backlog of new projects as a sign that it believes this is a temporary blip. It may well be but time will tell.

Europe has continued its recovery but progress in China has been slow. Whilst the company has said that trading is in line with expectations for 2017 as a whole, the tone of its trading statement suggests that first half performance has been quite sluggish and that the second half will have to be much better in order to meet those expectations. This is the main reason why the share price fell heavily.

Somero Enterprises Inc (SOM)

← 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		29.0	36.1	46.0	58.8	68.5	72.1
EBIT		4.1	7.7	11.5	15.7	19.1	19.7
Norm Pre-tax		4.1	7.5	11.4	15.8	19.4	19.8
EBIT margin		14.2	21.2	25.0	26.7	27.8	27.3
EPS(p)		5.8	15.2	13.1	18.5	22.5	23.6
EPS % chg		▲358.7	▲163.1	▼-13.9	▲41.5	▲21.5	▲4.9
DPS(p)		1.4	3.5	4.6	8.9	9.3	9.4
DPS % chg		▲180.1	▲150.4	▲32.8	▲93.3	▲5.0	▲1.1

In sterling terms, City analysts are expecting EPS growth of over 20% in 2017. This will include a full year effect of the lower vaue of the pound against the US dollar but still implies fairly strong underlying growth. Analysts are also still expecting the company to hit its sales target of $90m (£72m) in 2018.

Name	Close	Market Cap. (m)	fc PE	fc Yield	EBIT yield	EPV yield (8%)	EPV ps (8%)	EPV prem/disc to close (8%)
Somero Enterprises Inc	287.5p	£161.7	12.8	3.2	10.8	90.5	255.4p	-11.2

Ignoring cyclicality, the shares don't look to be expensive at current levels and have a decent dividend yield that will be enhanced with a special dividend of 13.3 US cents per share. The current high levels of profitability explain 90% of the company's enterprise value which suggests that the market is taking a cautious view on sustainable profits growth.

I think that's sensible given the increased risk of the company not hitting forecasts. The other concern would be the slow progress in the Chinese market. The media is littered with bearish stories about China's credit driven economy and a possible economic slowdown but that is only half the issue as far as Somero is concerned in my opinion.

It is not easy for Western manufacturers of high quality products to gain a foothold in the Chinese market. Over a decade ago when I was a small companies engineering analyst in the City, I remember walking around a factory floor with the chief executive of a UK comany looking to sell more of its products into China. He told me that his biggest worry was seeing a copy of his patented product being sold there for a fraction of its selling price. I would be surprised if Somero and its products was not subject to the same risk today.

Somero looks like a decent business operating in a cyclical market. Given the current high levels of profitability, I think the shares might find it difficult to make much progress for a while.

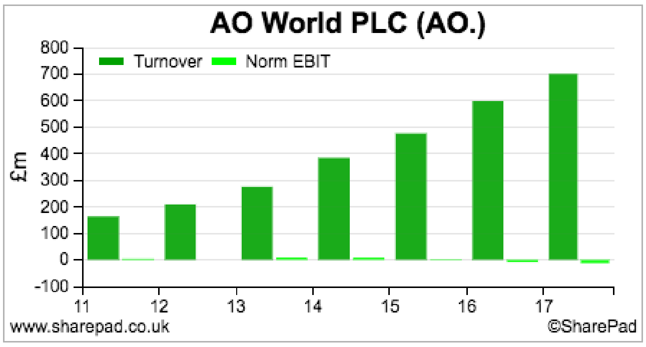
Share Discussion: AO World (AIM:AO.)

If I was going to set up a business I would not venture into the area of domestic appliances and electricals. It's far too competitive with lots of choices for shoppers and very thin profit margins.

To do well you have to sell lots of washing machines, TVs, fridges, dishwashers and computers. This will involve taking a sizeable chunk of market share away from established retailers such as Currys, John Lewis and Argos as well as local independent retailers.

This is what AO World is trying to do and it is having a very tough time if this week's full year results are anything to go by.

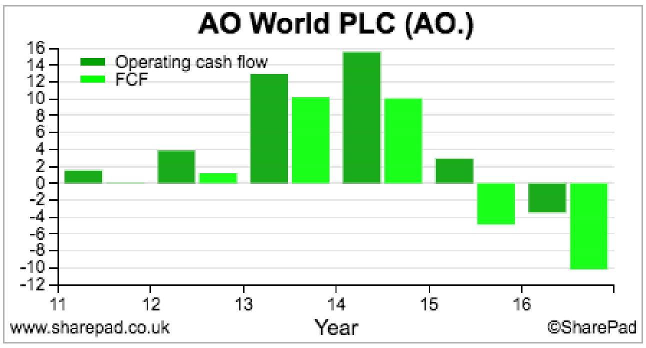
The company has been quite good at growing sales but turning those sales into profits has been largely elusive.

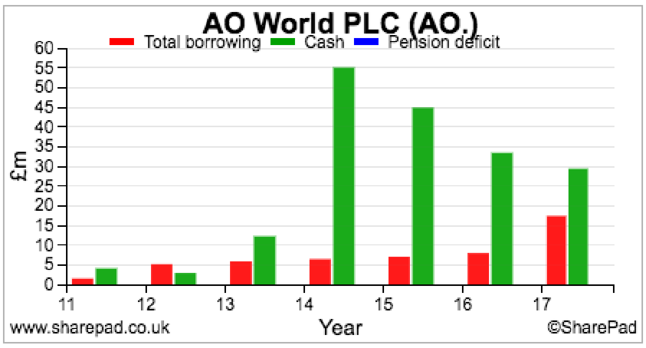


AO is making profits in its core UK market but its move into Germany and Holland is still heavily loss making and offsets all the UK profits. The overall operating loss increased from £10.6m to £12m.

AO	UK		Europe		Total	
	2016	2017	2016	2017	2016	2017
Sales	558.5	629.7	40.7	71.5	599.2	701.2
Gross profit	110.8	133.2	-4.9	-4	105.9	129.2
Gross profit	12.4	15.6	-23	-27.6	-10.6	-12
Gross margin	19.84%	21.15%	-12.04%	-5.59%	17.67%	18.43%
EBIT margin	2.22%	2.48%	-56.51%	-38.60%	-1.77%	-1.71%

The operating losses mean that AO is burning up cash flow.





Its cash balance has fallen for the third year in succession whilst its borrowings have increased. It is not really a surprise that just after the last financial year end in March that the company raised £50m from issuing new shares in a placing.

The company and its shareholders will be hoping that it can move into profit soon so that no further cash calls are needed. The big question is when will the company get back into profit again?

AO World PLC (AO.)

← Prev Next →	2014	2015	2016	2017	2018	2019
Fiscal period ending	31/3/14	31/3/15	31/3/16	31/3/17	1/3/18	1/3/19
£ millions unless stated	Q4	Q4	Q4	Q4	Forecast	Forecast
KEY FORECASTS						
Turnover	384.9	476.7	599.2	701.2	782.3	878.0
EBIT	8.2	2.1	(8.2)	(12.0)	-	-
Norm Pre-tax	7.9	1.4	(4.4)	(7.3)	(7.7)	0.5
EBIT margin	2.1	0.4	(1.4)	(1.7)	-	-
EPS(p)	1.5	0.4	(0.9)	(1.6)	(1.7)	0.1
EPS % chg	▼-12.0	▼-71.2	-	-	-	-
DPS(p)	-	-	-	-	-	-
DPS % chg	-	-	-	-	-	-

City analysts are currently expecting a small profit in 2019 but given the tone of the company's outlook statement this might be wishful thinking.

AO is trying to compete on service but my view is that as long as the price of the product is competitive and it is delivered safely and on time then that's all customers are likely to be concerned about. I don't see how it gets a competitive edge over John Lewis and Currys who will have much better buying power with manufacturers.

AO is also having to compete with a challenging market backdrop. Profits in the UK business fell during the second half of last year with gross margins falling due to higher purchasing costs caused by the devaluation of the pound. This pressure has continued into the start of its new financial year.

Throw in the fact that the company has said that first quarter growth is likely to slow significantly and you begin to question whether analysts' forecasts for an extra £80m of sales this year are achievable.

In some ways, forecasts are immaterial as far as the investment case for AO shares are concerned. With businesses such as this all the equity value is based on the future profits.

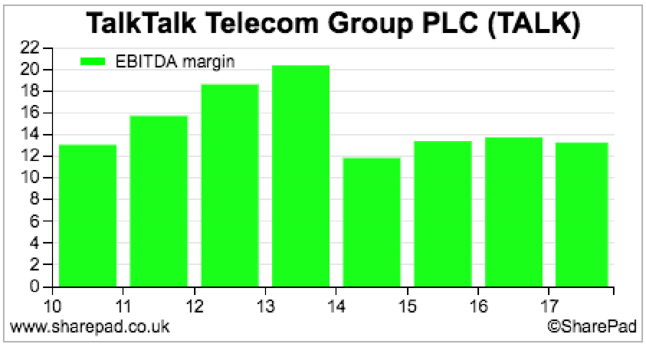
The company currently has an enterprise value of £530m if the £50m placing is taken into account and is currently producing operating cash flows of £3.5m. Dixons Carphone is expected to make profit margins of around 5% this year on sales of just over £10bn and trades on an historic EV/EBIT multiple of just over 10.

If I apply that multiple to AO's EV that gives me a trading profit figure of £53m. When is AO going to make that kind of profit? I've no idea and I don't think anyone else has either. What this back of the envelope kind of analysis points to is that even after a sinking share price since its IPO, AO's valuation still looks quite rich.

Share Discussion: Talk Talk Telecom (LSE:TALK)

I last looked at Talk Talk Telecom back in August 2015 (click **here** to read the article). Back then I highlighted that the company was borrowing to pay its dividend and that its sustainability was based on an ambitious target to generate 25% EBITDA margins by 2017. If it could do that then the dividend would be safe.

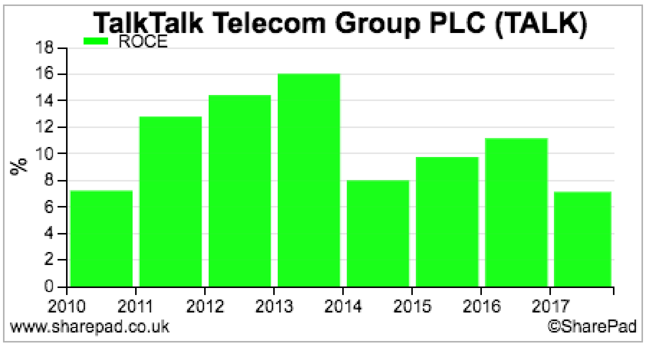
Just over a month ago, Talk Talk bowed to the inevitable and cut its dividend having fallen well short of its target. The dividend was slashed and will be cut again this year. Unsurprisingly, its shares have been hammered.

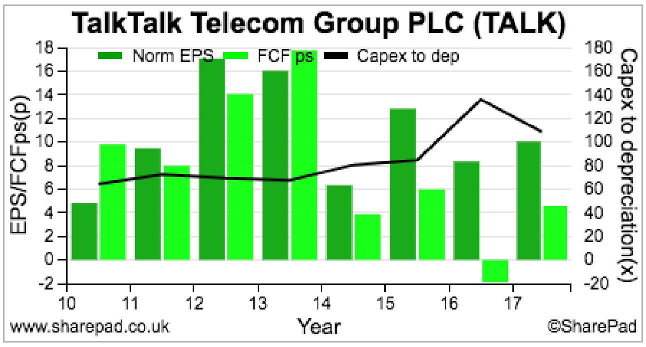


The shares have continued to be weak and it seems there is little appetite for them at the moment. Are investors treating the company too harshly and could the company - after being touted as a perennial takeover target - fall to a predator?

I am not so sure. Telecoms is a horrible space to be in at the moment. The worlds of media, broadband and mobile telecoms have converged into a fiercely competitive market.

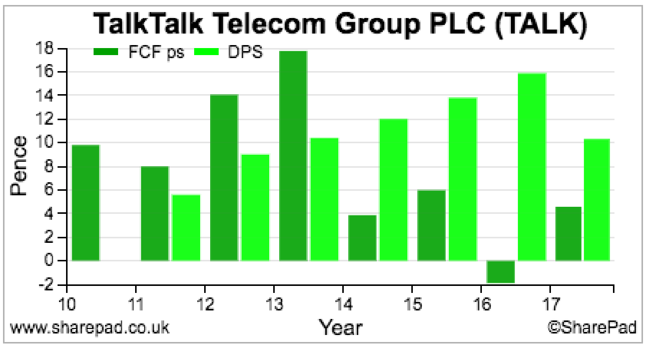
Talk Talk has positioned itself as a no frills, value for money telecoms provider but its strategy is not paying off. Profits have been falling and ROCE is very poor.





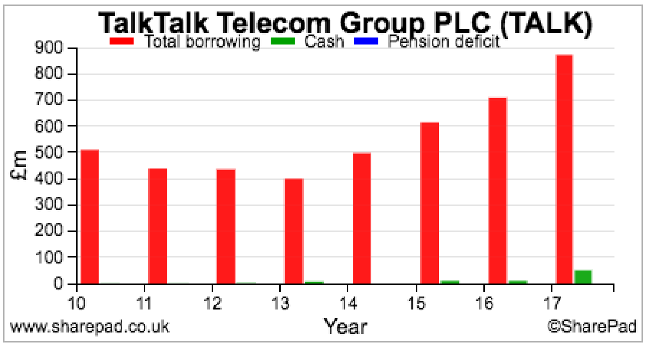
The company's weakness remains its poor free cash flow conversion which continued last year.

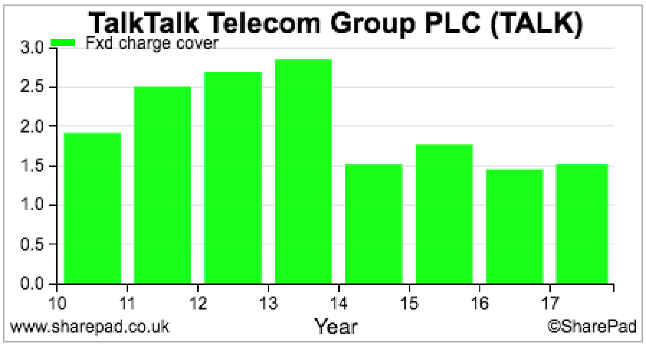
The company has not generated enough free cash flow to cover its dividend payment since 2013 and is the major reason why the dividend has been cut.



But there are grounds to believe that even the 2018 dividend per share target of 7.5p is unaffordable given that free cash flow per share was only 4.6p per share last year.

Debt levels have been increasing and fixed charge cover of around 1.5 times is not very comfortable.





Building an investment case on cost cutting rarely works well. Growth is what matters. Talk Talk is going to have to start growing its customers in a profitable way and this is not going to be easy. Both BT and Sky are offering very good deals to woo customers with arguably a better product. It's therefore going to be hard to get people to switch.

None of the major telecoms providers seem to be highly regarded for their customer service but Talk Talk continues to have problems in this area. It lost a lot of customers following a cyber attack a couple of years ago and has continued to lose market share over the last couple of years.

The company is trying to appeal to people who want to reduce their broadband spending and do not want to be tied into expensive TV contracts. It is after Netflix and Amazon Prime Video users who want cheaper and reliable broadband. This seems a sensible strategy and has begun to show up in customer growth and reduced churn (the number of customers leaving) during the last quarter of the 2016/17 financial year.

TIDM	Name	Close	Market Cap. (m)	fc PE	fc Yield	EBIT yield	EPV yield (8%)	EPV ps (8%)	EPV prem/disc to close (8%)
BT.A	BT Group PLC	302.9p	£30170.5	10.5	5.3	7.5	75.6	176.4p	-41.8
TALK	TalkTalk Telecom Group PLC	167.1p	£1595.8	14.0	6.0	3.9	40.7	17p	-89.8
TEP	Telecom plus PLC	£12.97	£1043.9	23.1	3.7	3.9	38.3	472.4p	-63.6
KCOM	KCOM Group PLC	90p	£464.9	16.7	6.7	6.2	63.1	52.5p	-41.7

I think it's going to take a long time to turn Talk Talk around if indeed it can be done at all. Ignoring the dividend yield - which is by no means safe in my view - I don't think the shares are particularly cheap. I don't like the Telecoms sector as it's virtually impossible to earn decent returns on capital. If I had to own a share in this sector, I'd probably prefer BT to Talk Talk at current prices.

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