Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

7th July 2017

Market overview

Shares in general are struggling to make much headway at the moment. That's not too surprising given how strongly they have performed during the last year - particularly smaller company shares.

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	7337.28	▼-0.177	▼-2.49	▲2.72	▲13.5	7547.63	6463.59	2/6/17	6/7/16
FTSE 250	19369.1	▲0.117	▼-1.45	▲7.15	▲23.6	20024.9	15669.7	26/5/17	6/7/16
FTSE SmallCap	5581.9	▲0.0568	▼-0.261	▲8.53	▲26.6	5661.48	4408.17	26/5/17	6/7/16
FTSE AIM 100	4768.33	▼-1.41	▼-2.3	▲17.1	▲44.1	4969.33	3308.83	2/6/17	6/7/16
S&P 500	2421.1	▲0.0579	▼-0.339	▲8.14	▲15.3	2453.46	2085.18	19/6/17	4/11/16
UK Treasury 10 Year Par Yield	1.26	▲0.8	▲24.8	▼-0.787	▲46.5	1.54	0.61	26/1/17	12/8/16
Brent Oil Spot $	$48.795	▲2.24	▼-2.38	▼-14	▼-0.924	$56.965	$41.965	29/12/16	2/8/16
Gold Spot $ per oz	$1223.88	▼-1.63	▼-5.4	▲6.38	▼-10.4	$1366.48	$1128.22	6/7/16	15/12/16
GBP/USD - US Dollar per Bri...	1.29671	▼-0.119	▲0.471	▲5.58	▲0.378	1.34149	1.20401	6/9/16	16/1/17
GBP/EUR - Euros per British...	1.13705	▲0.066	▼-0.703	▼-3.18	▼-2.32	1.2023	1.1066	14/7/16	13/10/16

As I've mentioned in a few of my recent articles I am struggling to find high quality shares to buy at reasonable prices and I am not prepared to pay silly prices for growth. As well as building up my cash balances, I have been buying some cheapish high-yielding shares recently which have been overlooked in recent months.

It's not my preferred strategy but I think that it suits my conservative approach. This week I've written an article about how **dividend shares** might help protect portfolios when perhaps other areas of the market are not as attractive as they were.

Dividend compounding with the reinvesting of dividend income can be a good way to slowly build up the value of your savings and increase the income from your portfolio. Like many of you, I am looking to use my SIPP portfolio to produce an income to live on eventually and a dividend compounding approach helps with that as well as protecting some of my gains made over the last few years.

Generally speaking, you should focus on shares not markets. Have the confidence to stick with your strategy whatever it may be. Remember, you don't have to invest if you can't find anything attractive. Having some spare cash is rarely a bad thing and gives you the option to buy good companies at good prices in the event of a general market correction.

Top 10 FTSE All-Share winners

No.	TIDM	Name	%chg 1w
1	OXB	Oxford BioMedica PLC	▲29.1
2	NVA	Novae Group PLC	▲23.8
3	NANO	Nanoco Group PLC	▲22.3
4	WPG	Worldpay Group PLC	▲16.8
5	PRTC	Puretech Health PLC	▲13.8
6	GLE	MJ Gleeson PLC	▲12.3
7	VM.	Virgin Money Holdings UK P...	▲11.1
8	VED	Vedanta Resources PLC	▲10.5
9	HNT	Huntsworth PLC	▲9.65
10	EVR	Evraz PLC	▲9.51

Top 10 FTSE All-Share losers

No.	TIDM	Name	%chg 1w
1	MTC	Mothercare PLC	▼-11.2
2	WIN	Wincanton PLC	▼-9.43
3	CNCT	Connect Group PLC	▼-7.17
4	TYMN	Tyman PLC	▼-7.07
5	FSTA	Fuller Smith & Turner PLC	▼-6.93
6	ACA	Acacia Mining PLC	▼-6.74
7	DOM	Domino's Pizza UK & IRL PLC	▼-6.35
8	PNN	Pennon Group PLC	▼-6.28
9	UPGS	UP Global Sourcing Holding...	▼-6.16
10	DCG	Dairy Crest Group PLC	▼-5.61

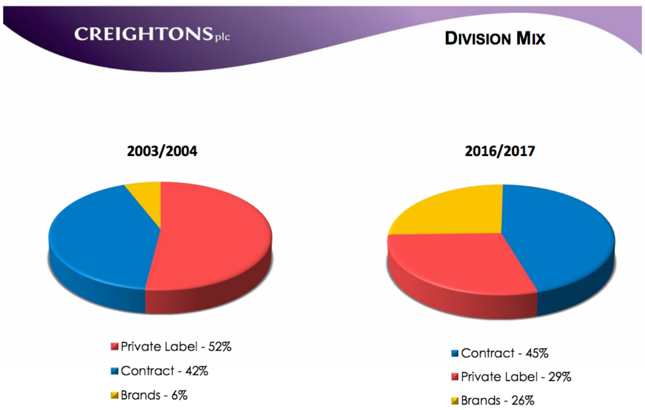
Share Discussion: Creightons (LSE:CRL)

One of the big advantages you have as a private investor is that you are free to invest in very small companies that the big professional investors cannot or will not. Most City brokers are not interested in very small companies because the shares are typically quite illiquid and they cannot make enough commission income from trading them. Investors who rely on broker forecasts to make buy or sell decisions will also ignore them.

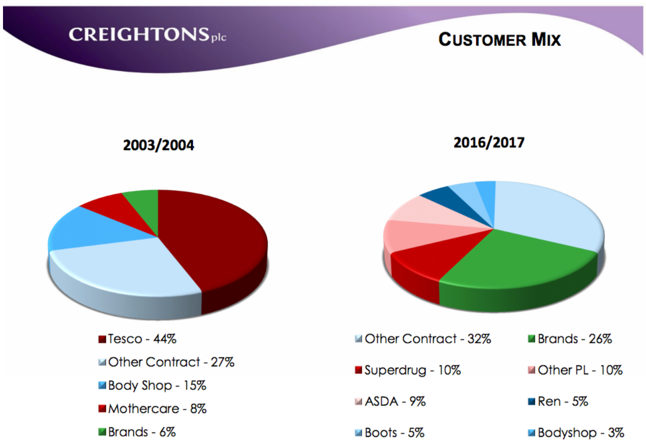
The diligent private investor who can identify a very small company with a good business can generate super returns from such companies as their profits grow. This has been the experience of patient long-term investors in Peterborough-based health and beauty products company Creightons. Its shares surged higher last week after it released an excellent set of full year results.

One of the drawbacks of small companies is that their communications with investors can sometimes be a bit disappointing and not particularly useful in helping people to understand their business. Creightons' results release was pretty thin on detail but it did publish the slides from an investor presentation on the internet (not on its own website unfortunately) which were very informative.

The company specialises in designing, making and selling health and beauty products. Its business is split into three distinct areas - its own brands, making private label brands for retailers and contract sales where it makes the products for other companies' branded products.

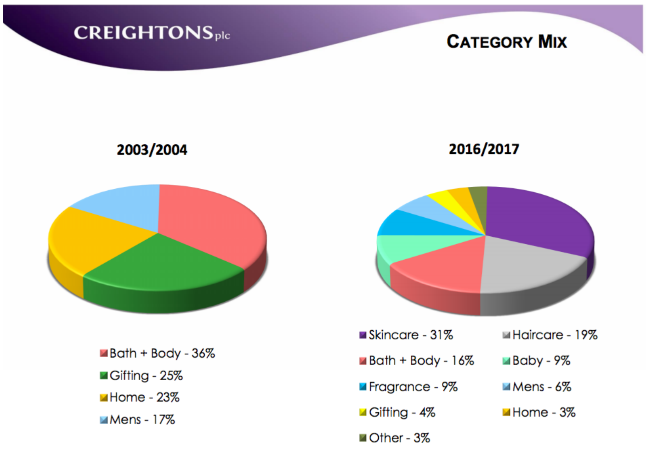


The company has significantly changed the mix of its sales over the last decade. It has gone from being predominantly a private label business, heavily reliant on Tesco (not usually a good position for a supplier to be in) to a much more balanced one.

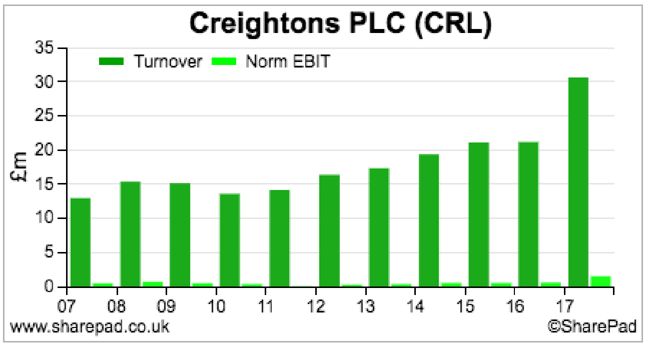


As well as diversifying its customer base, it has significantly improved the number and range of its products. It covers the whole range of the value chain from very cheap and functional products to premium offerings. Increased premiumisation of products gives the company an opportunity to earn higher profit margins going forward.

Skincare, haircare and bath and body products dominate the sales mix. However, the company is proving to be very good at bringing new products to market for both its own brands and contract customers.



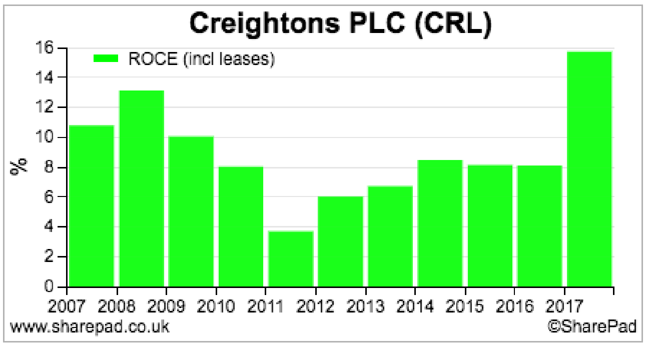
Full year results for the year to March 2017 were very good indeed. The company has been transformed by the acquisition of assets from Broad Oak Toiletries - a company that was in administration - back in February 2016. This has given it additional manufacturing capacity in Devon, along with a range of higher value products and customer contracts with which to grow the business.



Of the £10m of extra sales generated in the year around £7m came from acquisitions with the remaining £3m from organic growth. Organic sales growth of just over 14% is very impressive and came from strong growth in own brand sales (+16%) and contract sales (+38%) but was offset by tough trading in the private label sector which remains highly price competitive and promotional in nature (2 for 1 offers etc.).

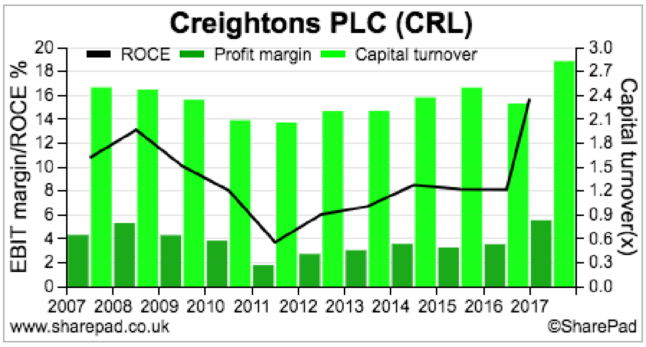
Operating profits almost tripled as the extra sales were leveraged on the tightly-controlled fixed costs of the manufacturing base. Even with the resumption of a taxation charge at a rate of 16%, diluted EPS increased by 123% to 1.88p which led to a dividend of 0.2p per share being proposed.

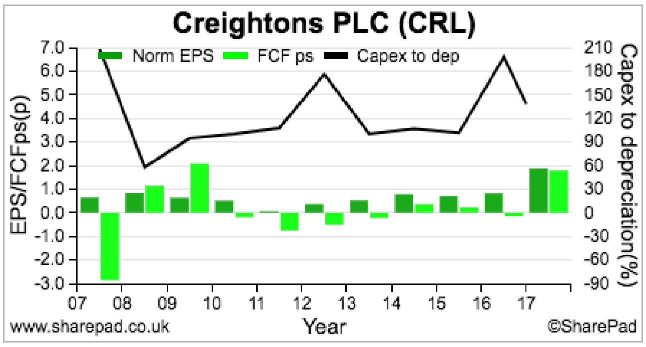
On my favourite company performance measure of return on capital employed (ROCE), it would appear that Creightons can now lay claim to being a very good quality business. Lease-adjusted ROCE was a very decent 15.7% last year which represented a step change in the financial performance of the company.

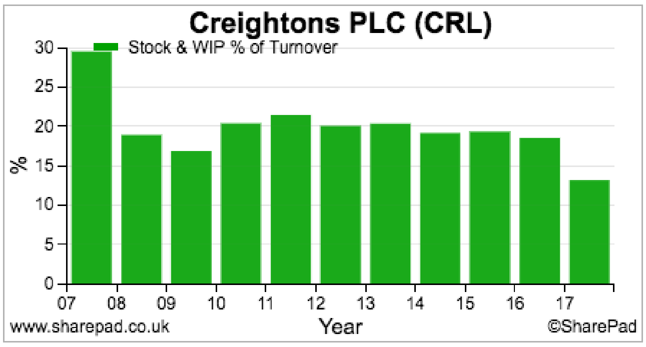


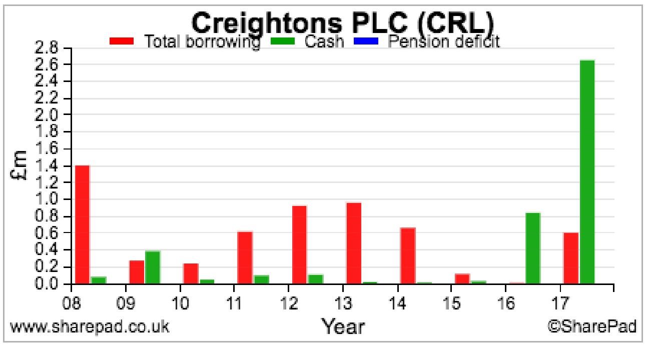
Creightons is a low profit margin business. It operates in fiercely competitive markets and is selling to large companies who have lots of buying power. Whilst profit margins have improved, it is never going to be able to achieve the double-digit profit margins that a large multi-national such as Unilever can.

Improvements in ROCE going forward are going to have to come from selling more on the existing asset base by improving capital turnover. As you can see from the chart on the right, Creightons has been doing just that which is a good sign.









Last year also saw Creightons massively improve the conversion of its profits into free cash flow which hasn't always been its strong point.

One key driver of improved cash flow has been a significant improvement in stock turnover which saw a sharp fall last year.

Stock control is a key issue for manufacturers. They have to have enough stock in order to facilitate growth but not have too much that it eats up cash flow and risks having to be sold at a loss in the future. The task for Creightons going forward is to demonstrate to its shareholders that last year's very good performance was not a one-off.

The company's finances are in good shape with minimal borrowings and net cash balance sheet position. The management team have alluded to the possibility of the company using its balance sheet strength to make acquisitions of brands or more manufacturing capability.

There is no broker coverage of Creightons at the moment but the company looks to be in a good position to keep on growing. Visibility for this kind of business is not great with order books typically accounting for around 3-4 months of annual sales. Having said that, I don't think I am being particularly reckless by suggesting that Creightons' profits are likely to be higher this year.

The market for premium beauty products is growing whilst retailers see their own label products as a good source of growth, particularly if consumers are feeling a little bit cash-strapped. There also seems more to go for from the assets acquired from Broad Oak in 2016.

My chief concern with Creightons is its low profit margins.

Low profit margins do not give companies much scope to withstand a fall in profitability and therefore carry an increased level of risk for customers. Creightons can mitigate this risk to some extent by selling more premium products with higher gross margins. Trying to pass on cost increases to large retailers is not easy but private label is a much lower proportion of sales than it was in the past.

What about the valuation of the shares?

They currently trade on just over 17 times last annual EPS. With growth, that multiple will come down. The management team has big ambitions to double sales to £60m and achieve a net (after tax) profit margin of 5% by 2020. If it could achieve that - probably with the help of some more acquisitions - it would have net income of £3m by then. Compare that with a current market capitalisation of £19.5m and the shares could be trading on a 2020 forecast PE of just 6.5 times which would make the current valuation of the business look very cheap indeed.

This makes me wonder whether Creightons could become a takeover candidate, perhaps for larger private label company McBride (LSE:MCB) which could arguably improve the underlying quality of its own business by buying it.

	CRL Personal Goods ①		MCB Household Goods & Home Construction	
HEADLINE				
Market cap	£19.5		£347.6	
Enterprise value	£17.5 m		£472.0 m	
Turnover	£30.6 m		£680.9 m	
EPS	1.9p		7.3p	
CONFIDENCE				
VALUATION				
Market cap	£19.5		£347.6	
PE	17.2	★	26.1	
EV / EBIT	11.6	★	16.0	
FORECAST GROWTH %				
SAFETY				
Fixed charge cover	4.6	★	3.9	
FCF conversion	95.7%		165%	★
Gearing	7.1%	★	169%	
Beneish M-score	-24.09	★	-2.43	
DIVIDENDS				
Dividend yield	0.7%	★	-	
FCF dividend cover	7.8	★	-	
Dividend cover	8.2	★	-	
Years of growth	0	★	-	
QUALITY				
ROCE	18.6%	★	13.3%	
EBIT margin	4.9%	★	4.3%	
Capital turnover	3.8	★	3.1	
CROCI	15.1%	★	12.3%	

Share Discussion: Northgate (LSE:NTG)

I first came across Northgate back in 2003 when I was a smaller companies analyst in the City. Back then there was little enthusiasm amongst investors to buy the shares of a van rental business. However, the company proved to be a very profitable investment during the latter phase of the last bull market.

Then the financial crisis hit. Northgate was heavily exposed to the UK and Spanish economies and owned lots of van assets with debt secured against them. The resulting financial mess took a long time to recover from but in recent years the company has performed reasonably well.

But could dark clouds be on the horizon again?

To understand Northgate as an investor you need to concentrate on a few key performance indicators:

- The size of the fleet.
- How often the fleet is out on hire - the fleet utilisation rate.
- The daily hire rate.
- The profits or losses from selling vans.
- The levels of debt.

Northgate's key selling point to customers is flexibility. Rather than owning a van outright or signing up to a long-term contract hire, customers can have the flexibility of renting one for as long as they need it and giving it back when they have finished with it. There is a small premium to pay for this flexibility but for some businesses (for example ones facing seasonal levels of demand) this arrangement can work well.

Northgate has been the UK market leader in commercial daily van rental (31% market share) for many years but the business seems to have hit a sticky patch. Last year was not good with UK operating profits falling from £55.4m to £43.9m.

By its own admission, the company may have taken its eye off the ball. The UK fleet shrank by nearly 3,000 vehicles although utilisation did improve to 88% from 87%. Ideally, this business should be getting close to 90% utilisation in order to optimise profits but there is a trade off between utilisation and hire rates. Management seems to have taken the sensible decision not to slash hire rates to boost utilisation.

Profits have also been held back by higher depreciation rates and lower profits on used van sales as residual values have fallen. Encouragingly, the company is still making profits on disposals (its sales proceeds less the net book value of the vehicle) which suggests that it is not under-depreciating its vehicles and overstating its profits.

The new chief executive is changing the strategy of the UK business slightly. It wants to have more vans on fixed term or contract hire. I am not sure whether this is a good thing or is more of a defensive move in order to keep fleet utilisation high.

Contract hire will be less attractive to some customers as it does not have the same flexibility as daily rental (you cannot give the van back when you want to). It is also arguably a more competitive marketplace.

Both rental and contract hire is well suited to exploit the trend away from outright ownership of vehicles amongst commercial van fleets. Whether the shift in emphasis will help Northgate to get its profits growing again remains to be seen.

Northgate PLC (NTG)

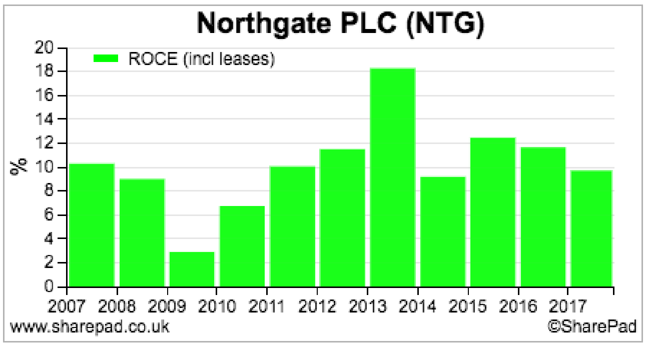
Prev Next	2015	2016	2017	2018	2019	2020
Fiscal period ending	30/4/15	30/4/16	30/4/17	1/4/18	1/4/19	1/4/20
£ millions unless stated	Q4	Q4	Q4	Forecast	Forecast	Forecast
KEY FORECASTS						
Turnover	614.3	618.3	667.4	675.8	695.1	743.7
EBIT	95.8	92.5	81.5	-	-	-
Norm Pre-tax	83.0	81.1	73.8	75.3	77.7	83.9
EBIT margin	15.6	15.0	12.2	-	-	-
EPS(p)	49.2	48.1	46.3	44.1	47.7	52.0
EPS % chg	▲46.4	▼-2.4	▼-3.7	▼-4.8	▲8.2	▲9.0
DPS(p)	14.5	16.0	17.3	18.6	19.2	21.5
DPS % chg	▲45.0	▲10.3	▲8.1	▲7.5	▲3.2	▲12.0

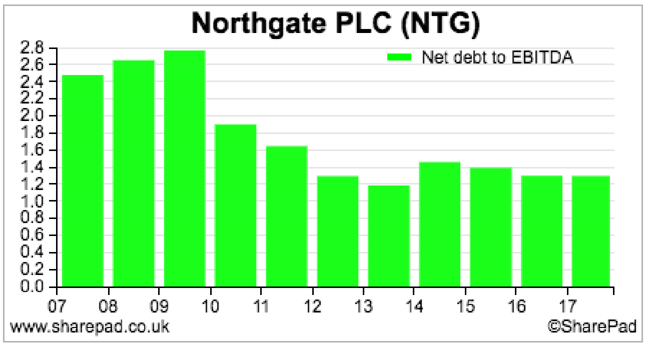
Northgate's Spanish business is performing satisfactorily and is expected to continue growing in 2017/18 with the small Irish business not expected to make much of a difference at the moment. My concern would be that the UK business will take some time to get back on an even keel which might be made difficult by a weakening economy.

Analysts are expecting another reduction in earnings per share in 2018 and I would be inclined to take 2019 forecasts with a pinch of salt.

Having said that, Northgate is a reasonable if not an outstanding business currently earning a respectable ROCE.

More importantly, the company is carrying a much more prudent level of debt compared with the last economic cycle.





Van rental businesses are naturally financed with a reasonable amount of debt. But as you can see, Northgate's net debt to EBITDA ratio - a common measure of a company's ability to cope with its debt load - is a very safe 1.3 times. This is backed up by an interest cover ratio (the amount of times trading profits can pay the interest on debts) of 8.5 times. Its financial position should therefore not keep investors awake at night.

Northgate shares do not look too expensive on 10 times forecast earnings and offer a decent dividend yield of over 4% which analysts expect to continue growing. We can also see that 90% of the current share price is explained by current trading profits.

This looks about right to me. The lack of profit growth in the short-term suggests that the shares could at best tread water for a while.

Name	Close	Market Cap. (m)	fc PE	fc Yield	EPV ps (8%)	EPV yield (8%)	fc PEG
Northgate PLC	439.3p	£585.3	10.0	4.2	406.9p	95.9	1.2

Share Discussion: Stagecoach (LSE:SGC)

Stagecoach shares have endured a torrid couple of years and have more than halved in value. The company's impressive bus profits and sector-leading margins have ground to a halt, but the company has got itself into a bit of a mess with its UK rail portfolio - most notably the East Coast mainline franchise.

Running UK rail franchises has become a high-risk business in recent years. In a sector where profits growth is hard to come by, rail franchises have been seen as a way of doing this.

The problem is that competition for London commuter and inter-city franchises has become too fierce. Companies are bidding for them by promising to pay the UK government large amounts of premiums over the life of the franchise.

These premium payments tend to increase every year. In order for a franchise owner to report a growing profit stream to its investors it has to get more passengers paying higher ticket prices year after year. If the growth assumptions are too optimistic in the franchise bid then profits can start falling and even move into losses.

This is what has happened with Stagecoach's East Coast franchise. This same franchise almost pushed National Express (LSE:NEX) into bankruptcy back in 2009 and is now putting Stagecoach under an increasing level of stress.

I am not surprised at all by this. Back in April last year (click **here** to read the article) I drew attention to slowing like-for-like sales at the company's rail division and the problems it might throw up. Last week's full year results revealed that the company is in a bit of a mess here.

The company cannot meet its obligation of paying the promised East Coast franchise premiums until 2023 without incurring losses. It has therefore created a provision for an onerous contract estimating cumulative losses of £84.1m. There has also been an impairment in intangible assets of a further £44.8m relating to the franchise.

Stagecoach is trying to renegotiate the terms of the franchise so that it can start making a profit from it again in 2019. However, there is no reason why the government should agree to this. Whatever happens, Stagecoach's credibility in UK rail has been severely damaged which may stop it winning future rail franchises.

Unsurprisingly, the shares have not reacted well to this news. It would seem that the only real support for the shares at the moment is the prospective dividend yield of 6.7%. But how safe is that?

I used to be a bus and rail analyst when I worked in the City and have always felt that some of the current crop of analysts covering the sector have been perhaps a little complacent when looking at the sustainability of rail profits. Companies can and do lose rail franchises - as Stagecoach has recently with South West Trains - and franchises do also disappoint financially.

When it comes to the sustainability of dividends, I always looked to calculate dividend cover based on the more reliable bus profits alone. Here's how Stagecoach shapes up under this analysis (see table on the right):

Dividend cover on bus profits alone is pretty thin. This could well explain the high dividend yield on the shares as there looks to be a risk that the dividend might have to be cut. Of course, management will do everything they can to avoid this.

Stagecoach forecast dividend cover based on 2016/17 bus profits (£m)	
Total Bus Profits	155.9
Group overheads	-14.1
Net interest	-34.1
Profit before tax	107.7
Estimated taxation @ 20%	-21.5
Profit available for dividends	**86.2**
Forecast DPS (p)	12.4
Shares in issue (m)	573.6
Dividend cost	**71.1**
Dividend cover	1.2 times

Stagecoach Group PLC (SGC)

← Prev Next →	2015	2016	2017	2018	2019	2020
Fiscal period ending	30/4/15	30/4/16	29/4/17	1/4/18	1/4/19	1/4/20
£ millions unless stated	Q4	Q4	Q4	Forecast	Forecast	Forecast
KEY FORECASTS						
Turnover	3,204.4	3,871.1	3,941.2	3,425.8	2,975.5	2,805.0
EBIT	213.5	179.6	47.3	140.7	134.9	149.9
Norm Pre-tax	171.6	137.3	137.6	151.7	137.4	133.1
EBIT margin	6.7	4.6	1.2	4.1	4.5	5.3
EPS(p)	25.2	21.9	26.2	21.8	19.3	18.6
EPS % chg	▲5.6	▼-13.3	▲19.9	▼-16.8	▼-11.5	▼-3.6
DPS(p)	10.5	11.4	11.9	12.4	12.6	12.9
DPS % chg	▲10.5	▲8.6	▲4.4	▲4.2	▲1.6	▲2.4

Analysts are painting a picture of declining profits ahead but as yet there are no predictions of a dividend cut. Note that dividend growth is expected to almost grind to a halt.

Stagecoach	EPS (p) 2018F	EPS (p) 2019F
December 2016	22.2	21.9
July 2017	21.8	19.3

There has been a significant reduction in 2019 EPS forecasts since I last reviewed the shares in the December 9th **newsletter**. I am a little surprised that 2018 forecasts have not changed that much - as the level of expected rail profits must be lower than it was then - whilst bus profits remain lacklustre.

Shareholders will hope that things can turn around soon - and they might if a deal can be done with the government on the East Coast franchise. However, there is a risk that forecasts are subject to downgrades which makes the shares still quite a risky proposition despite how far they have already fallen.