Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

15th September 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	7391.93	▲0.514	▲1.12	▲3.49	▲10.9	7547.63	6665.63	2/6/17	13/9/16
FTSE 250	19600.2	▼-0.265	▲0.283	▲8.42	▲11	20024.9	17271.2	26/5/17	4/11/16
FTSE SmallCap	5701.05	▼-0.196	▲0.471	▲10.8	▲16.8	5742.98	4862.64	8/8/17	11/11/16
FTSE AIM 100	5109.45	▼-0.746	▲1.59	▲25.5	▲34.7	5188.4	3794.58	1/9/17	13/9/16
FTSE All-Share	4048.83	▲0.36	▲0.96	▲4.53	▲11.1	4130.15	3641.91	26/5/17	4/11/16
S&P 500	2495.6	▲1.22	▲2.22	▲11.5	▲17.3	2496.48	2085.18	12/9/17	4/11/16
UK Treasury 10 Year Par Yield	1.24			▼-2.36	▲36.3	1.54	0.69	26/1/17	28/9/16
Brent Oil Spot $	$54.525	▲0.646	▲4.86	▼-3.93	▲15.5	$56.965	$44.565	29/12/16	11/11/16
Gold Spot $ per oz	$1322.71	▼-0.807	▲2.61	▲15	▲0.119	$1349.10	$1128...	7/9/17	15/12/16
GBP/USD - US Dollar per Bri...	1.32435	▲1.52	▲1.79	▲7.84	▲0.387	1.32888	1.20401	12/9/17	16/1/17
GBP/EUR - Euros per British...	1.11145	▲1.6	▲1.04	▼-5.36	▼-5.48	1.1972	1.0795	18/4/17	29/8/17

Stock markets are holding up well close to their record highs. I don't have much to say about where they are likely to go over the next few weeks as I don't think investors should spend much time worrying about them. Just concentrate on companies instead unless of course you are investing in passive tracker funds.

The big economics story of the week is the continuing rise in UK inflation - now at 2.9% based on the consumer prices index (CPI). This is close to the 3% level where Mark Carney must write a letter to the chancellor explaining why the Bank of England has not kept inflation close enough to its 2% target.

There are calls for higher interest rates in the UK to bring inflation down. What seems quite clear is that the decision to cut interest rates after the EU referendum as well as printing more money for quantitative easing was not that wise with hindsight.

For what it is worth, I don't think interest rates will rise in the UK for a long time. We had inflation of over 5% back in 2011 and nothing was done. The Bank of England know that the UK economy - and also its housing market - is reliant on cheap money and will be loathe to put increasingly maxed out consumers under any more pressure for fear of killing the economy.

Inflation is a worry in America as well. This explains why the price of gold has been rising. It is up 15% in dollar terms since the start of 2017. The pound has strengthened against the dollar since then and has continued to do so in recent weeks meaning that Gold prices are up by only 7.5% in sterling terms. This compares with a 7.7% increase in total returns from the FTSE All-Share index.

Inflation is seen as being good for gold prices but UK investors need to pay close attention to the pound's value against the dollar. Inflation may cause the gold price to go up but if it causes the value of the dollar to weaken against the pound as well then buying some gold for your portfolio might not work out as well as you think it might.

Top 10 FTSE All-Share winners

No.	TIDM	Name	%chg 1w
1	ALM	Allied Minds PLC	▲25.6
2	EXI	Exillon Energy PLC	▲25.4
3	VEC	Vectura Group PLC	▲15.1
4	JD.	JD Sports Fashion PLC	▲14.4
5	NANO	Nanoco Group PLC	▲14.3
6	NXT	Next PLC	▲14.1
7	SOPH	Sophos Group PLC	▲9.32
8	GVC	GVC Holdings PLC	▲8.96
9	STHR	SThree PLC	▲6.78
10	ARW	Arrow Global Group PLC	▲6.06

Top 10 FTSE All-Share losers

No.	TIDM	Name	%chg 1w
1	IRV	Interserve PLC	▼-54.6
2	UPGS	UP Global Sourcing Holdings ...	▼-51
3	SPI	Spire Healthcare Group PLC	▼-19.9
4	SERV	Servelec Group PLC	▼-17.2
5	HOC	Hochschild Mining PLC	▼-14.7
6	GNK	Greene King PLC	▼-14.4
7	RDW	Redrow PLC	▼-12.1
8	KAZ	KAZ Minerals PLC	▼-12
9	CEY	Centamin PLC	▼-11.9
10	LMI	Lonmin PLC	▼-11.9

Share Discussion: Sophos Group (LSE:SOPH)

Last week I looked at software company EMIS. This week, I am turning my attention to another software company - Sophos Group.

Sophos is an IT security company. It sells network and end user security products and services to medium-sized companies exclusively through a network of distributor partners. Its aim is to make the issue of IT security more simple and easier to manage for its customers. It currently has around 260,000 customers.

The company and its share price have been performing well. That said, a look at the company's financial statements could easily confuse many investors and perhaps put some of them off investing in it.

There are two main issues as far as I can see.

1. The company says it makes a profit but its income statement says it makes a loss.
2. Its profits and cash flows are markedly different from one another.

Let's take a look at both these issues in turn:

Does Sophos make a profit?

A quick look at Sophos' income statement shows a loss for the year to March 2017 of $44.3m. Yet the company says that it actually made an adjusted operating profit of just over $38m. It explains this in a note to its accounts.

	Year-ended 31 March 2017 $M	Year-ended 31 March 2016 $M
Operating loss	(44.3)	(32.7)
Amortisation of intangible purchased assets	19.9	29.2
Share-based payments expense	31.3	15.0
Exceptional items	31.4	41.9
Adjusted operating profit	38.3	53.4
Depreciation	9.4	8.4
Foreign exchange loss / (gain)	–	2.4
Net deferral of revenue	102.4	56.7
Cash EBITDA	150.1	120.9
Billings	632.1	534.9
Revenue	(529.7)	(478.2)
Net deferral of revenue (note 24)	102.4	56.7

The exceptional items number is quite big but most people accept in most cases it is fair enough to exclude them from the calculation of underlying profits. I would spend some time looking at what they actually are but am not going to do that just now.

Amortisation of intangible purchased assets is a controversial subject as far as costs are concerned. Of the $19.9m expensed, $7.4m relates to the writing off of intellectual property, $7.0 to software (amortised over 3 years) and $5.5m on others.

Software expenses are real as the company spent $5.0m on new software assets during the year. So perhaps the $7.4m amortisation should be subtracted from underlying profits.

Share-based payments are not a cash cost but they are a real expense as far as shareholders are concerned. That's because they are a transfer of value from them to employees - shareholders are worse off because of them. Personally, I don't agree with ignoring them even though they are a non-cash expense.

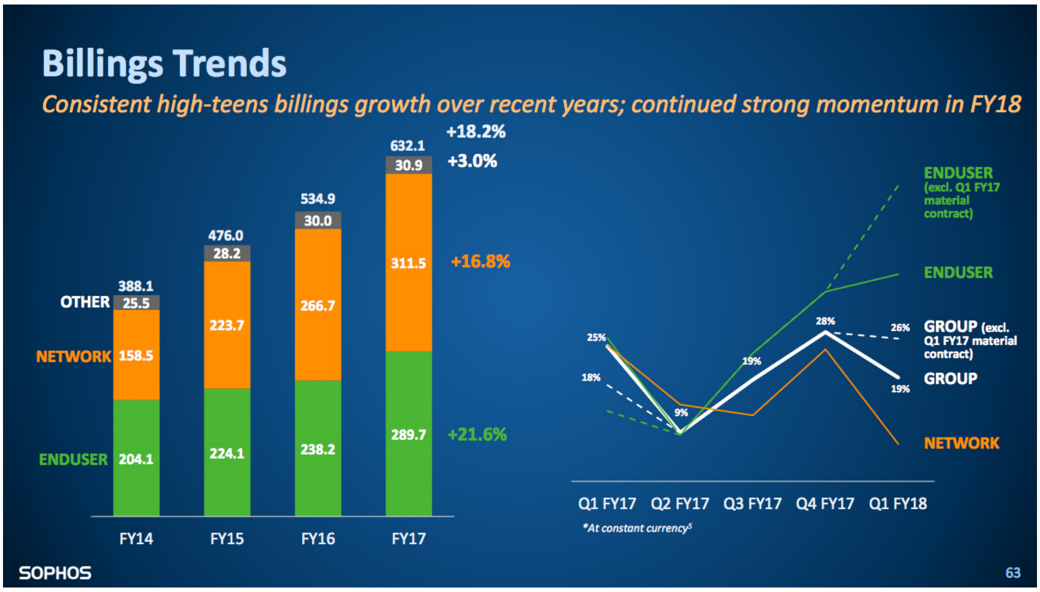
So taking away $7.4m of software amortisation costs and $31.3m of share-based payments from the adjusted operating profit figure could lead me to suggest that Sophos is not profitable and made an underlying loss of $0.4m.

The company likes to focus on the cash coming into the business and looks at year on year changes in cash EBITDA. This is underlying profit plus depreciation plus the net deferral of revenue and was $150.1m in 2017.

As I explained last week with EMIS, deferred revenue is a major feature of subscription software businesses. Customers pay in full, in advance for an annual or multi-year subscription. The company receives the cash but most of that cash is unearned income.

This is because the income has to be matched against costs over the period it is earned. This company can only show it as income in its income statement as it is earned. For example, a £120 annual subscription would see £10 earned per month until the whole subscription had been used up.

Sophos has provided some very useful information for investors on how money received from billings and subscriptions works its way through to revenues and profits.

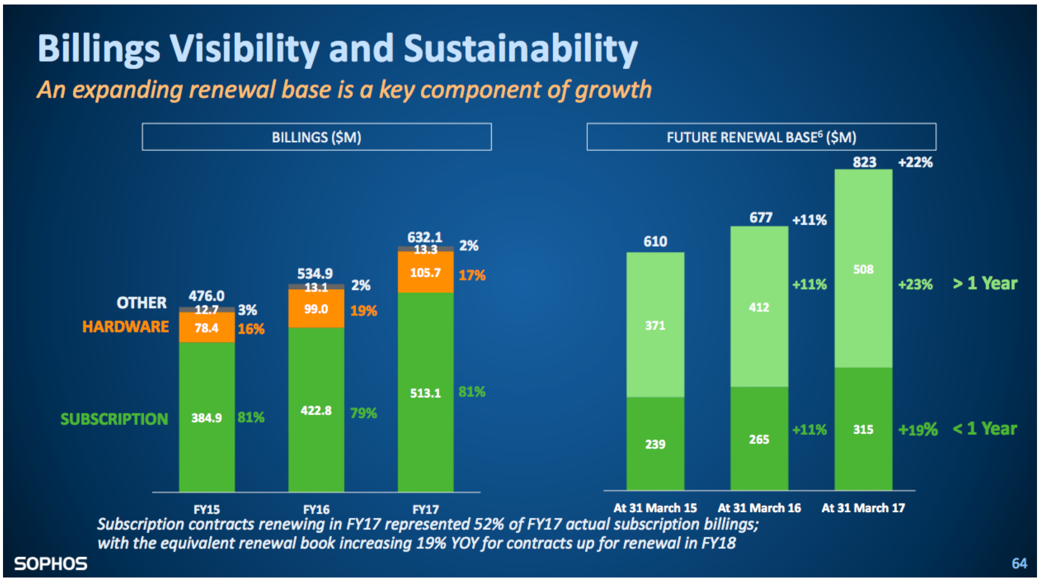


First of all, we can see that Sophos has been growing its number of billings to customers over the last few years. This is a good sign of a healthy growing business. The amount of billings has also been higher than revenues which is also a good sign.

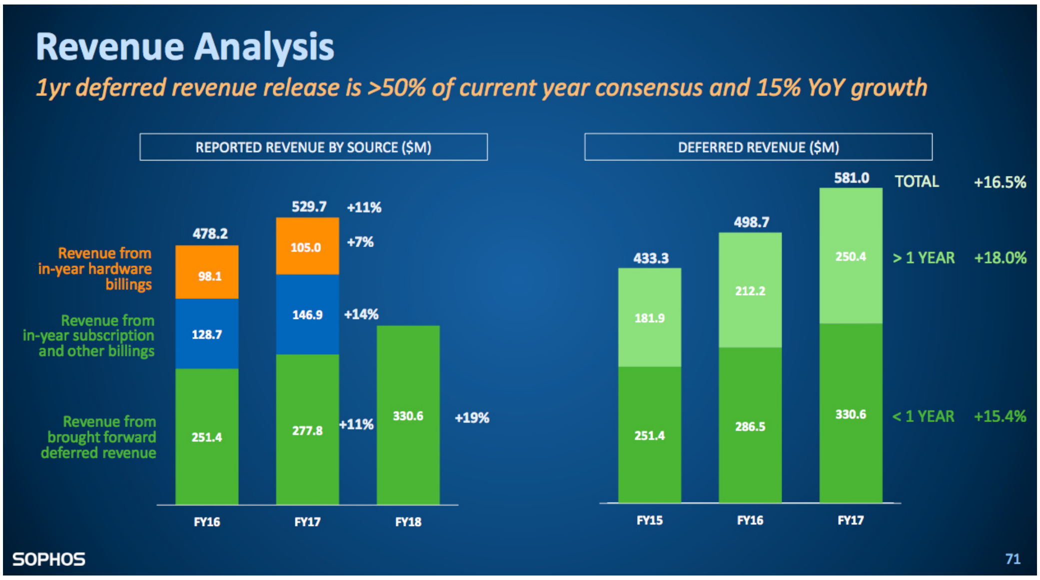
Year($m)	Billings	Revenue	Billings to Revenue	Net deferred revenue
2017	632.1	529.7	119%	102.4
2016	534.9	478.2	112%	56.7
2015	476	446.6	107%	29.4

The difference between billings and revenue - known as net deferred revenue - has also been growing which is good.

81% of Sophos' revenue is subscription based which gives it a high level of potential recurring income. As the chart below shows, this could feed through into meaningful revenue growth.



The growth in billings has led to a growth in deferred revenue as shown below. This gives the company and its investors great visibility on future revenues. Over 50% of 2018's revenues are already in the bag as they have been paid for in advance.



But I think it is wrong for Sophos to add net deferred revenue to EBITDA and say it is a measure of cash earnings because a large chunk of those earnings have not been earned yet.

So how does an investor work out how profitable Sophos might be now or in the future?

I think it is quite difficult for a private investor who is not following this company like a professional analyst to really try and work out what is going on. The fact that the company seems to be barely profitable - due to my harsh stance on share-based payments - is a concern.

Any profit and valuation has to be based on matching revenues and costs. Large cash inflows from deferred income make huge distortions to free cash flow and are not likely to be representative of sustainable basis for valuing Sophos.

Investors should be very cautious about the large free cash flow numbers being projected. Whilst it is good to receive cash upfront it should not be mistaken for a large increase in underlying profits and company value in my view.

If we look at the amount of cash flow coming into the business from trading activities then of the $137m coming through the door, almost all of that was due to revenue received in advance (deferred income) and the adding back of share-based pay expenses.

The company has set itself a target of $1bn in annual billings by 2020 and to improve its profit margins at the same time. If it can do this then the revenue that will accrue over time should start to see profits increase.

CONSOLIDATED STATEMENT OF CASH FLOWS

For the year-ended 31 March 2017

	Note	Year-ended 31 March 2017 $M	Year-ended 31 March 2016 $M
Loss for the year		(46.7)	(71.9)
Adjusted for:			
Depreciation		9.4	8.4
Amortisation of intangible assets		19.9	29.2
Amortisation of fair value adjustment on deferred income		(1.0)	(1.8)
Foreign exchange		–	2.4
Share-based payments	30	31.3	15.0
Finance income	12	(0.1)	(0.7)
Finance costs	12	5.1	36.4
Income tax (credit) / charge		(2.6)	3.5
		15.3	20.5
Decrease / (increase) in inventories		1.1	(6.7)
Increase in trade and other receivables		(20.5)	(16.1)
Increase / (decrease) in trade and other payables		37.1	(10.9)
Increase in deferred revenue		104.4	59.4
Increase in provisions		0.3	0.3
Cash generated from continuing operations		137.7	46.5

Sophos is aiming for profits of more than $100m and free cash flow of $220-$240m (which will include a large chunk of deferred revenue) by 2020.

At a share price of 566p, the company has an enterprise value of £2.86bn. With an exchange rate of £1=$1.326 this equates to $3.79bn. If we assume $100m of trading profits (EBIT) in 2020 then the business is currently valued at 37.9 times 2020 operating profits or an EBIT yield of 2.6%. That's expensive in most peoples' eyes.

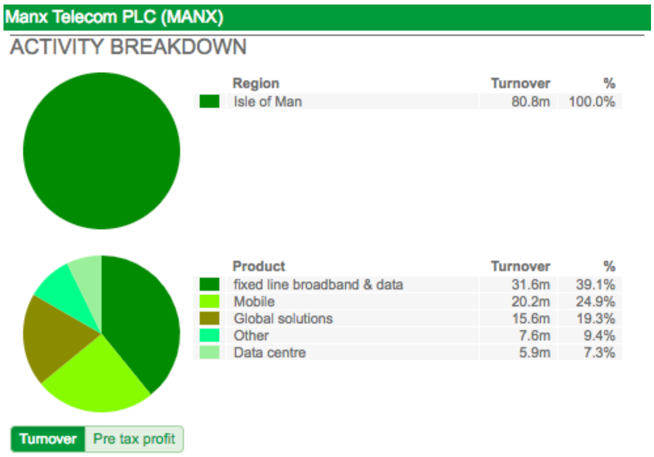
The growth in billings and customer numbers is a sign that Sophos has some good products that resonate well with business. This is also shown in the company's high retention rate. The shares have performed extremely well this year and have more than doubled in price.

I can see why someone would like the business story and growth here but feel a lot of good news has already been priced in.

Share Discussion: Manx Telecom (AIM:MANX)

Manx Telecom is the Isle of Man's equivalent of BT. It provides fixed line, broadband, mobile and data services to households and businesses across the island and faces very little competition - except from Betelco which operates under the Sure brand.

It also has other businesses such as Global Solutions which uses the company's mobile technology to provide services outside the island such as bulk text messaging for companies, stronger mobile signals and mobile services for overseas travellers. A Data Centre business stores important data for companies on the island to meet demand for services such as disaster recovery.



Region	Turnover	%
Isle of Man	80.8m	100.0%

Product	Turnover	%
fixed line broadband & data	31.6m	39.1%
Mobile	20.2m	24.9%
Global solutions	15.6m	19.3%
Other	7.6m	9.4%
Data centre	5.9m	7.3%

The company benefits from not having to pay corporation tax on its profits which means that all its post interest profits belong to its shareholders.

Manx's strategy is to maintain its dominant market share on the island and grow revenues by moving customers onto better services such as high speed broadband and 4G mobile services. It is also targeting growth from its Global Services and its Data Centre. Most of the company's profits will be paid out in dividends to shareholders with the intention of paying a growing dividend.

Half year results announced this week showed that the company is more or less on track with delivering its strategy. Profits took a hit from the loss of two major customers from the Data Centre business but the underlying business looks to be doing quite well.

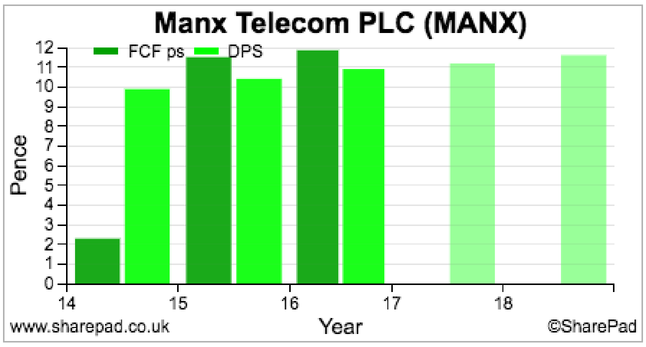
Revenue	H1 2017 GBP'000	% Total Revenue	H1 2016 GBP'000	% Total Revenue	YoY %
Fixed Line, Broadband and Data	15,568	40.5%	16,027	40.9%	(2.9%)
Mobile	10,209	26.5%	9,857	25.1%	3.6%
Global Solutions	7,891	20.5%	6,986	17.8%	13.0%
Data Centre	2,318	6.0%	3,424	8.7%	(32.3%)
Other	2,507	6.5%	2,918	7.5%	(14.1%)
Total Revenue	38,493		39,212		(1.8%)

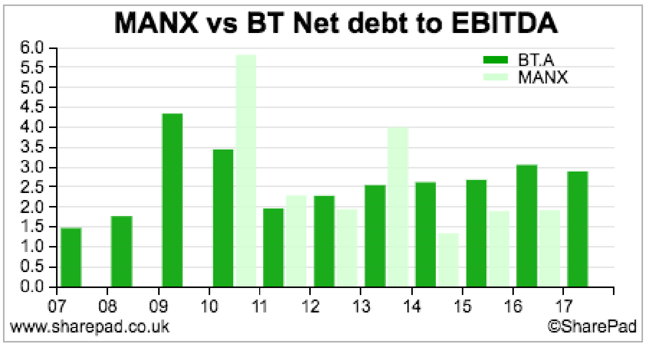
The company is experiencing similar trends to most mature telecom businesses in that high speed broadband and mobile services are seeing growing revenues whilst traditional fixed line voice revenues continue to fall. The Global Solutions business saw some good growth which is expected to continue for the rest of the year.

Given the limited growth prospects for the core telecoms business on the island it is unlikely that Manx is going to deliver meaningful profit growth in the years ahead. The shares are for income seekers and here the story looks to be reasonably good with the interim dividend increasing by 5.4% to 3.9p per share.

The key to maintaining and growing the dividend is the company's free cash flow. As you can see from the chart below, free cash flow per share has been more than sufficient to pay the dividend for the last couple of years. If free cash flow can be maintained - and perhaps grow a little bit with growth from high speed broadband and Global Services' revenues - then there is scope for the dividend to keep on growing modestly in my view.

During the first half of the year, free cash flow was held back by costs associated with a business transformation programme aimed at making the business more efficient. Excluding these costs, underlying free cash flow was £7.3m or 6.4p per share which more than covered the interim dividend declared of 3.9p.





Unlike BT, Manx is not burdened with a big pension fund deficit and has a lower net debt to EBITDA ratio when pension liabilities are taken into account.

It also doesn't have to spend huge amounts of money on sports rights to defend its broadband market. This arguably makes Manx a safer telecom income play for investors than BT.

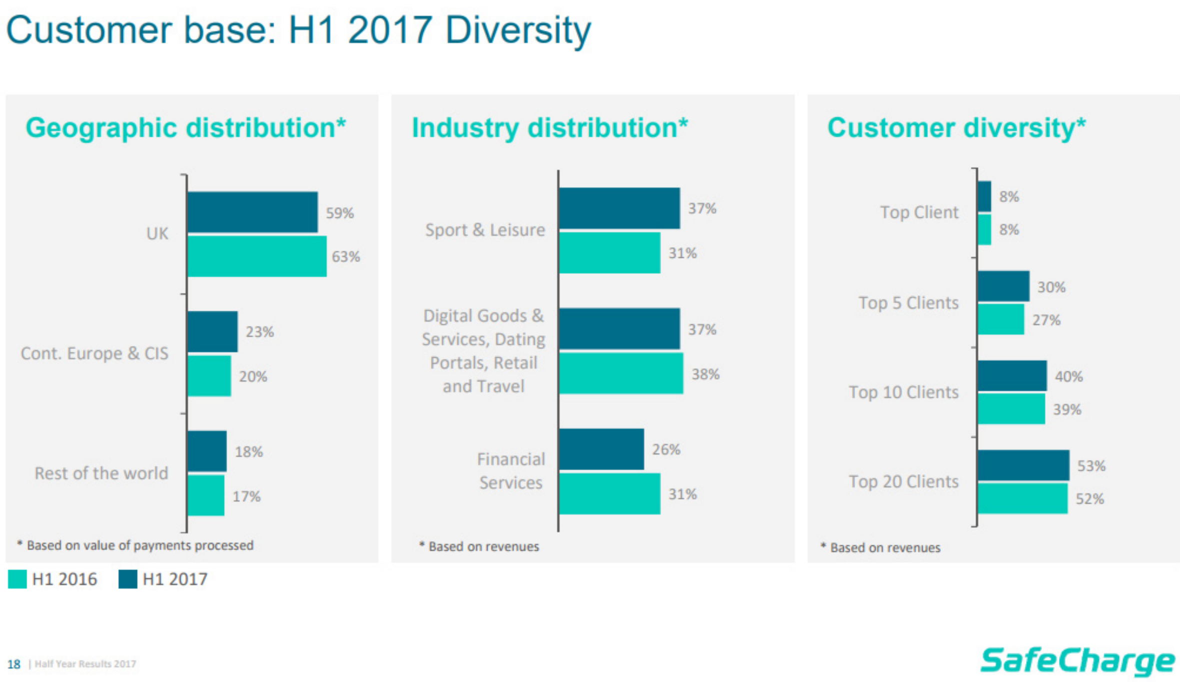
Manx Telecom PLC (MANX)

← Prev Next →	2014	2015	2016	2017	2017	2018
Fiscal period ending	31/12/14	31/12/15	31/12/16	30/6/17	1/12/17	1/12/18
£ millions unless stated	Q4	Q4	Q4	TTM	Forecast	Forecast
KEY FORECASTS						
Turnover	79.3	79.6	80.8	80.1	81.4	83.3
Norm EBITDA	40.5	27.6	30.2	27.0	27.9	28.6
EBIT	31.0	18.5	21.1	17.5	-	-
EBIT margin	39.1	23.3	26.1	21.9	-	-
Norm Pre-tax	21.4	16.5	17.6	18.4	16.3	16.9
EPS(p)	20.2	14.5	15.4	16.1	14.2	14.8
EPS % chg	▲453.8	▼-28.1	▲6.2	▲27.5	▼-7.7	▲4.2
Dividend per share Adj	9.9	10.4	10.9	11.1	11.2	11.6
Dividend per share %chg Adj	-	▲5.1	▲4.8	▲4.7	▲2.8	▲3.6
Dividend cover	2.0	1.4	1.4	1.5	1.3	1.3

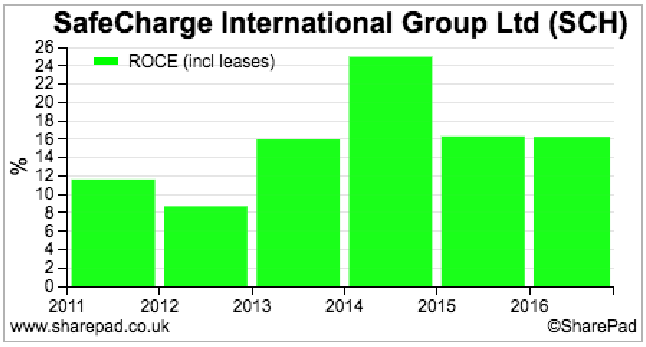
You are unlikely to get very rich owning shares of Manx Telecom but at a share price of 196p they do offer a prospective dividend yield of 5.7% which you could tuck away and sleep quite soundly with.

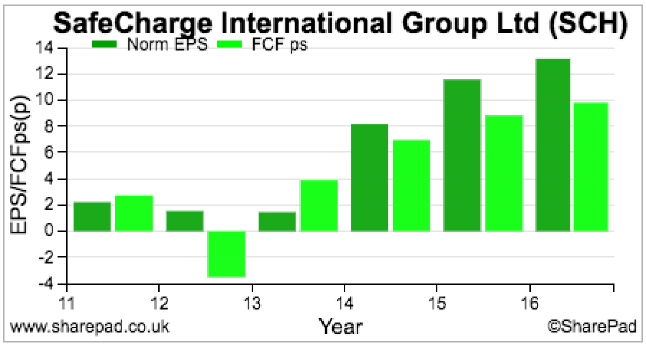
Share Discussion: SafeCharge International (LSE:SCH)

SafeCharge is an online payments and fraud protection business. It offers secure online and mobile payments services for customers and businesses. It makes most of its revenue in the UK and has significant customer revenues from betting and gaming companies, retailers, online travel agents and financial services companies.



These kind of businesses can have some very attractive financial characteristics. By that I mean decent returns on capital employed (ROCE) as shown in the chart below.





And also an ability to convert most of its profits into free cash flow.

SafeCharge looks reasonable on both these measures. If these can be combined with an ability to grow sales and profits in the future then it has the makings of the kind of company that I like to invest in.

Growth is a bit of an issue based on this week's half year results. The number of transactions and the value of transactions on Safecharge's platform grew by 30% and 7% respectively which fed through to an 11% growth in underlying revenues.

Unfortunately, profits did not follow suit. Operating profit was down by 8.5% and profit for shareholders was down by 20%. On a brighter note, the trading cash flow performance was reasonable and there was a 10% increase in the interim dividend.

The company blamed its poor profit performance on changes to its customer base made in 2016. It seems reasonably confident that sales and profits will pick up from new business from new customers.

That said, the tone of the company's statement was a little bit cautious and explains why the share price fell on the day of the results:

> *"During the period, the Group successfully launched a fully serviced global payment solution to Tier 1 customers and it has a strong sales pipeline,* ***although the revenue growth to maturity from these long-term Tier 1 clients is taking slightly longer than anticipated****"*
>
> *"The Group has enjoyed a strong start to the second half of 2017 benefiting from the launch of new clients, many of whom had started processing on the Company's global acquiring platform by the end of the first half of the year. The Board remains confident t****hat the outcome for the year will be broadly in line with market expectations****, and the Directors look forward with confidence to the rest of 2017 and beyond."*

Investors are not slow to pick up on the tone of company outlook statements. "Slightly longer than anticipated" and "broadly in line" will rightly raise suspicions that growth is slower than expected and that profit forecasts are at risk.

SafeCharge reports in US dollars whereas SharePad forecasts are in pounds and pence. This will have an impact on growth rates but weaker sterling will not have much of an effect during the second half of the year

SafeCharge International Group Ltd (SCH)

← Prev Next →		2015	2016	2017	2017	2018	2019
Fiscal period ending		31/12/15	31/12/16	30/6/17	1/12/17	1/12/18	1/12/19
£ millions unless stated		Q4	Q4	TTM	Forecast	Forecast	Forecast
KEY FORECASTS							
Turnover		65.3	77.1	79.1	84.7	97.3	112.0
Norm EBITDA		19.5	24.2	23.8	-	-	-
EBIT		17.4	21.1	20.6	-	-	-
EBIT margin		26.6	27.4	26.0	-	-	-
Norm Pre-tax		17.8	21.2	20.9	29.2	24.3	28.3
EPS(p)		11.6	13.1	13.4	15.7	18.1	20.1
EPS % chg		▲41.4	▲13.8	▲9.5	▲19.5	▲15.3	▲11.0
Dividend per share Adj		7.7	12.9	13.5	12.6	11.7	13.6
Dividend per share %chg Adj		▲47.1	▲66.7	▲29.5	▼-2.3	▼-7.1	▲16.2
Dividend cover		1.5	1.0	1.0	1.2	1.5	1.5

Based on the trailing twelve months performance (TTM) these forecasts look a bit optimistic to me and I would not be surprised to see them come down.

Having said that, SafeCharge shares are not particularly expensive. At first glance at 252p they are trading on 18.8 times TTM EPS which doesn't look that tempting. However, there was $113m (just over £85m) of cash on the balance sheet at the end of June or 58p per share. Strip this out and the shares are on a cash adjusted PE of 14.5x which begins to look more reasonable.

The payment services sector is consolidating as providers look to gain scale, cut costs and deal with increasing competition. Worldpay has been taken over on a multiple of just over 19 times trailing earnings as has Paysafe on a multiple of around 16.4 times 2017 forecast earnings. Could Safecharge be the next to be taken over?

Possibly, but it needs to concentrate on getting growth going again. If it can do that, I don't see too much company-specific downside to the current share price.